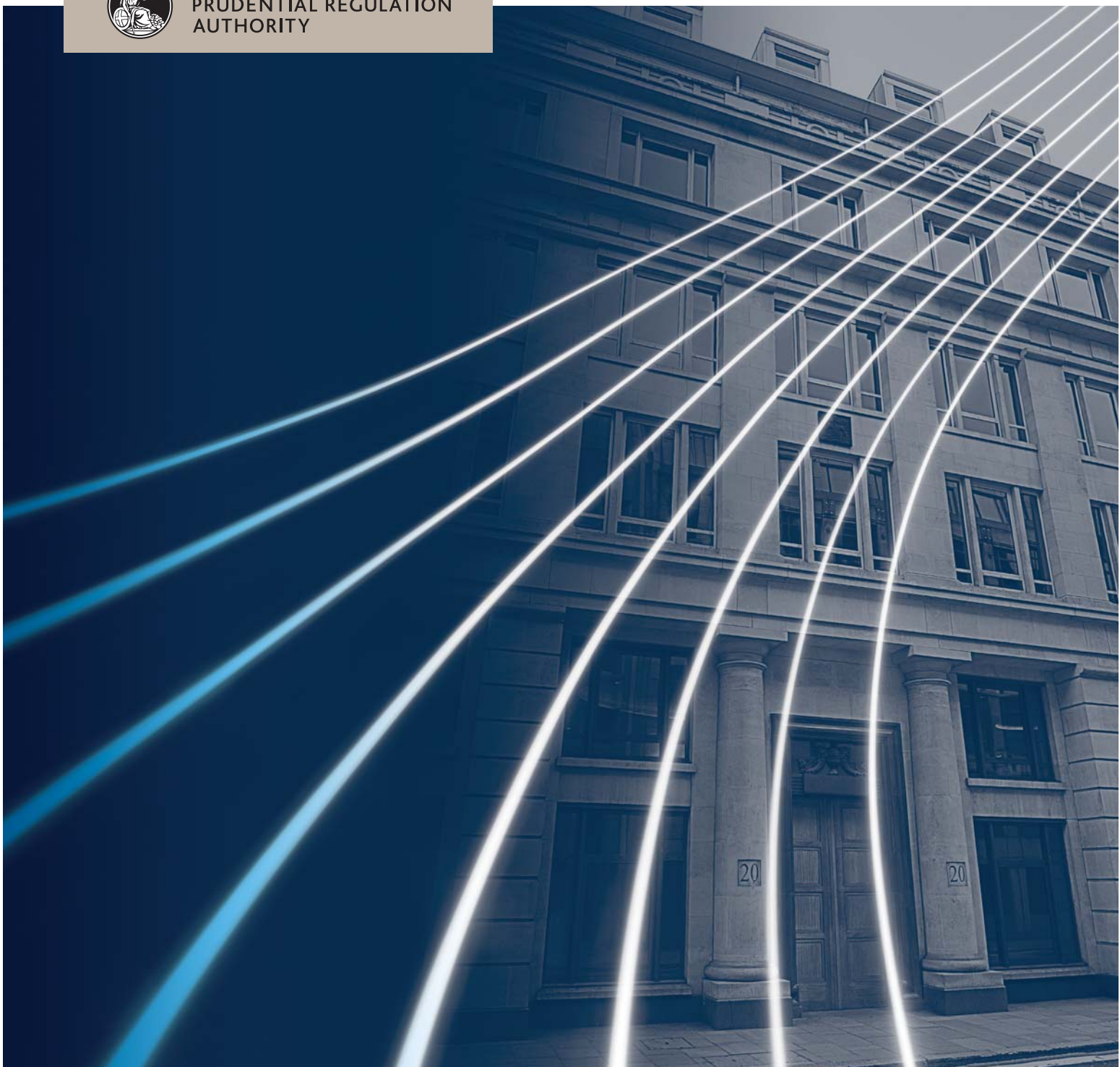


# The Prudential Regulation Authority's approach to banking supervision

June 2014



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY





## Foreword



**Andrew Bailey**

Chief Executive Officer, Prudential Regulation Authority

The Prudential Regulation Authority (PRA) is the United Kingdom's prudential regulator of deposit-takers, insurers and major investment firms. As part of the Bank of England, the PRA makes an important contribution to the Bank's financial stability objective of protecting and enhancing the stability of the UK financial system, and likewise supports the objective of the Monetary Policy Committee to maintain price stability in the United Kingdom. In the same way, the work of the Bank of England as a whole supports the PRA in delivering its objectives.

The PRA has two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. In 2014, the PRA gained a secondary objective; to promote effective competition in the markets for services provided by PRA-authorized firms. I welcome this change to our objectives, and the clarity that it provides.

The PRA's objectives are underpinned by the principle that a stable financial system, which is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy. Firms can adversely affect the stability of the financial system through the way in which they carry on their business and in the extreme by failing in a disorderly manner. It will not, however, be the PRA's role to ensure that no firm fails. Rather, the PRA will seek to ensure that any firms that fail do so in an orderly way that avoids significant disruption to the supply of critical financial services, and thus to the PRA's primary objectives.

The introduction of the secondary competition objective will enhance the PRA's focus on competition. The PRA will keep the prudential regime under review to consider changes that might further its competition objective without undermining the PRA's general and/or insurance objective.

This document is revised from the version published in April 2013. It sets out how the PRA will advance its primary objectives in relation to deposit-takers and designated investment firms. A companion document covers insurers. The document contains a number of changes reflecting amendments to legislation, and our supervisory approach since the commencement of the PRA in April 2013. The main changes are summarised in an annex. We intend to publish an explanation of how the PRA will pursue its secondary competition objective, and I envisage that this will be included in the next edition of our approach documents.

We continue to focus our approach on strengthening the UK financial system through being a forward-looking and judgement-based prudential regulator. This means that we proactively take action in order to pursue our objectives, for example by introducing regular stress tests of firms. Rightly in my view, there has been a lot of focus on the banking industry from all corners of society. The PRA is at the forefront of ensuring that the United Kingdom has a resilient and stable financial services industry, which is the role that we play in the wider programme of reforming the financial services industry. Over the past year, the major UK banks raised in excess of £30 billion of new, higher-quality capital to ensure they meet the new regulatory requirements. These changes will help to ensure firms are better protected against potential future losses, while refinements in liquidity have also been achieved.

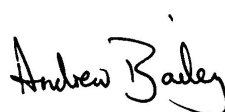
We remain committed to applying the principle of proportionality in our supervision of firms. In this context, proportionality is judged in terms of the threats that firms can pose to the PRA's primary objectives. An important first step in the direction of applying the principle of proportionality is described in the publication on barriers to entry for new firms.<sup>(1)</sup> Also, for smaller firms, we have used cross-firm thematic supervision to identify and address specific areas of concern.

The PRA will evolve its approach to supervision to take account of new developments. For instance, the Parliamentary Commission on Banking Standards made a number of recommendations relevant to the PRA including the creation of a new Senior Persons Regime to replace the existing Approved Persons Regime. In addition, we have set out how we intend to supervise firms from within and outside the European Economic Area,<sup>(2)</sup> a key piece of our work which has now progressed to the consultation phase, in line with the intentions set out in our previous approach to supervision documents, including our expectations of the treatment of UK creditors and depositors by branches of overseas firms.

We continue to co-ordinate closely with the Financial Conduct Authority (FCA). This has been essential to the successful advancement of the PRA's objectives this year. The PRA and the FCA have committed to working together and co-ordinating across a range of areas. The PRA and the FCA have different objectives, though, and the benefits of the new regime will only be achieved if both institutions focus on their own responsibilities. Further detail on how the PRA works with the FCA is set out in the Memorandum of Understanding between the two regulators, and in Box 4 of this document.

The Bank of England recently announced changes to its strategy and structure and in doing so adopted a single mission to promote the public good through achieving and maintaining financial and monetary stability. There is a natural synergy between macro and microprudential regulation and our strategy is to conduct supervision as an integrated part of the central bank. We have already seen the benefits of this in our first year of operations. The PRA has worked in concert with the Financial Policy Committee and firms to better understand the principal risks in the banking system. Our *Annual Report*<sup>(3)</sup> sets out the progress we have made.

Much has been achieved during the first year of the PRA, and I would like to extend my thanks on behalf of the Board of the PRA to all our staff for their dedication and contribution, and to PRA-regulated firms for their continued feedback. There remains much still to do, not least ending 'too big to fail' and ensuring the resolvability of large and complex firms. Those are challenges on which we will seek to make decisive progress over the next twelve months, supported by the Bank of England's new Strategic Plan and organisational structure.



June 2014

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(1) For more information on barrier to entry, see [www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf](http://www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf).  
(2) For more information, see the consultation paper on supervising international firms, available at [www.bankofengland.co.uk/pr/Pages/publications/supervisingintbankcon.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/supervisingintbankcon.aspx).  
(3) Available at [www.bankofengland.co.uk/publications/Documents/annualreport/2014/prareport.pdf](http://www.bankofengland.co.uk/publications/Documents/annualreport/2014/prareport.pdf).

## Contents

---

Foreword	1
----------	---

---

Executive summary	5
-------------------	---

---

Introduction	7
--------------	---

---

<b>I</b>	<b>The PRA's approach to advancing its general objective</b>	<b>8</b>
	The PRA's primary general objective	8
	The PRA's approach to advancing its objective	9
Box 1	The PRA's Threshold Conditions	10
Box 2	The PRA's Fundamental Rules	11
Box 3	Underlying economic justification for prudential regulation	12
Box 4	Working with other authorities	14

---

<b>II</b>	<b>Identifying risks to safety and soundness</b>	<b>16</b>
	Potential impact	16
	External context	17
	Business risk	17

---

<b>III</b>	<b>Safeguarding safety and soundness</b>	<b>19</b>
	Management and governance	19
	Risk management and controls	22
	Capital	23
	Liquidity	26
	Resolvability	28

---

<b>IV</b>	<b>Supervisory activity</b>	<b>30</b>
	Assessing risk	30
	Proactive Intervention Framework	31
	Mitigating risk	33
	Using powers in the course of supervision	33
	Enforcement powers	35
Box 5	Authorising new firms	31
Box 6	International approach	34
Box 7	Use of powers to address serious failings in the culture of firms	36
Box 8	Supervision of firms that pose little individual risk to financial stability	37

---

<b>V</b>	<b>Making policy to support the PRA's general approach</b>	<b>38</b>
Box 9	Staffing the PRA	39

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Annex	41
-------	----



## Executive summary

The Prudential Regulation Authority (PRA), as part of the Bank of England, is the United Kingdom's prudential regulator for deposit-takers, insurance companies and designated investment firms. This paper sets out how the PRA carries out its role in respect of deposit-takers and investment firms. It is designed to help regulated firms and the market understand how the PRA supervises these institutions, and to aid accountability to the public and Parliament.

### The PRA's objective

The PRA has a primary objective to **promote the safety and soundness of firms**. It is required to pursue this primarily by **seeking to avoid adverse effects on financial stability**, and in particular seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or upon their failure. In discharging this objective, the PRA will focus, in particular, on the risk of disruption to the continuity of supply of critical economic functions.<sup>(1)</sup> This is because a stable financial system, that is resilient in providing the supply of critical economic functions the economy needs, is a necessary condition for a healthy and successful economy.

Seeking to minimise the adverse effect of the failure of a firm does not require the PRA to take steps to avoid any and all such adverse effects or to prevent all instances of failure. The statute is explicit that **it is not the PRA's role to ensure that no firm fails**. Firm failures happen, but the PRA seeks in particular to ensure that they do not result in significant disruption to the supply of critical economic functions, including depositors' ability to make payments. Assessing and planning to contain the impact of failure by developing feasible and credible resolution plans for its firms is a core part of the PRA's supervisory work. Its ability to do this depends on the efficacy of the statutory resolution regime, on which the PRA works with the rest of the Bank.

The PRA also has a secondary objective to facilitate effective competition. It will, while advancing its primary objectives, so far as reasonably possible, facilitate effective competition in relevant markets. This secondary objective only applies when the PRA is advancing its primary objectives and therefore does not operate as a self-standing objective. The fact that the competition objective is secondary to the primary objectives means that the PRA should not take steps to facilitate competition to an extent that would be inappropriate for the safety and soundness of the firms it regulates.

Nevertheless, the PRA must and will be mindful of the likely competition effects of its actions. The PRA's work on barriers to entry is one example of this approach.

As with the primary objectives, the secondary objective only requires the PRA to take action to the extent it is reasonably

possible to do so. The PRA will consider a range of factors, including the factors which the PRA is required to have regard by statute and the constraints imposed by EU law.

### The PRA's requirements on firms — Threshold Conditions

The requirements that firms need to meet in order to remain safe and sound are rooted in the PRA's statutory objective, the statutory Threshold Conditions for authorisation, and UK and EU law. The PRA's statutory Threshold Conditions, which set out the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage, are designed to promote safety and soundness and are crucial to the operation of the PRA's regulatory regime. In broad terms, they require firms to have an appropriate amount and quality of capital and liquidity, to have appropriate resources to measure, monitor and manage risk, to be fit and proper, and to conduct their business prudently. **The PRA expects firms not merely to meet and continue to meet the letter of these requirements, but also to consider the overriding principle of safety and soundness.**

Maintaining safety and soundness at times requires firms to act more prudently than they might otherwise choose. Their incentives can sometimes be to take more risk, and so to impose more risk on the stability of the financial system and economy, than is in the public interest.

### The PRA's requirements on firms — Fundamental Rules

The Fundamental Rules are high-level rules, which collectively act as an expression of the PRA's general objective of promoting the safety and soundness of regulated firms. The rules apply to all PRA firms (subject to legal restrictions) irrespective of size and business carried on.

As with the Threshold Conditions, **it is vital that boards and senior management understand the Fundamental Rules, the more detailed rules in the PRA Rulebook and the directly applicable EU regulations, and establish within their firms a culture that supports adherence to the spirit and the letter of the requirements.**

### The PRA's approach to supervision

Within the statutory framework, **the PRA's approach relies significantly on judgement. The PRA supervises firms to judge whether they are safe and sound, and whether they meet, and are likely to continue to meet, the Threshold Conditions.** Supervisors will thus reach judgements on the risks that a firm poses to the PRA's objective and how to address any shortcomings.

(1) The PRA defines critical economic functions that firms provide to be — payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; custody services; life insurance; and general insurance.

**The PRA's approach is forward looking; it assesses firms not just against current risks, but also against those that could plausibly arise in the future.** Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage. Firms should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible prudential concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

**The PRA focuses on those issues and those firms that pose the greatest risk to the stability of the UK financial system.**

Focusing on key risks inevitably implies tailoring activities to a firm's individual circumstances. The PRA's supervision reflects the nature of a firm, whether a bank, building society, credit union or investment firm. Consistent with its focus on key risks, the PRA aims to concentrate on material issues when engaging with firms. The frequency and intensity of supervision applied by the PRA to a particular firm therefore increases in line with the risk it poses.

The PRA's supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the firm. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. To minimise such outcomes, the PRA needs to be staffed by teams with strong, relevant skills and experience, and its major judgements and decisions involve the PRA's most senior and experienced staff and directors.

The PRA also engages with the boards and senior management of firms in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements, and to communicate clearly the rationale for them. Firms should not, however, approach their relationship with the PRA as a negotiation.

**The PRA's regulatory decision-making is rigorous and well documented, consistent with public law.** Its most significant supervisory judgements are taken by its Board — comprising for these purposes the Governor of the Bank of England, the

Deputy Governor for Financial Stability, the Deputy Governor for Markets and Banking, the Chief Executive Officer of the PRA, and the independent non-executive members of the Board.<sup>(1)</sup> The PRA Board is involved in the most important decisions on general policy and individual cases. The Board is, of course, accountable to Parliament, in the same way as are the Monetary Policy Committee and Financial Policy Committee (FPC), the Bank's other statutory decision-making bodies.

### The wider context

An effective framework for financial stability needs to **combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole.** The PRA therefore works closely with the rest of the Bank of England, including, crucially, the FPC, which is able to make recommendations and give directions to the PRA.

The PRA also co-operates closely with the rest of the Bank on, for example, market intelligence and oversight of critical financial infrastructure, and with the Bank's Resolution Directorate on resolution planning, contingency planning for firm failure and operational resilience.

**The PRA co-operates closely with the Financial Conduct Authority (FCA),** which is the conduct regulator for PRA-licensed firms and the conduct and prudential regulator for many other UK firms. As set out in the Memorandum of Understanding between the two authorities, this co-ordination recognises their separate, independent mandates and statutory objectives.

Reflecting the international nature of the banking industry and capital markets, and in particular the United Kingdom's membership of the single market in EU financial services, **the PRA plays a full and active role with its counterparts globally and in the European Union.** The PRA, at times as part of the wider Bank, also actively participates in global forums like the G20, Financial Stability Board, Basel, International Association of Insurance Supervisors etc in developing and implementing prudential standards and in supervising international firms.

(1) The CEO of the FCA is also a non-executive member of the Board, but does not take part in regulatory decisions. The addition of the Deputy Governor for Markets and Banking to the PRA's Board was announced by the Chancellor and the Governor as part of the Bank's Strategic Review. For more information, see [www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments](http://www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments).



## Introduction

1. The PRA is the United Kingdom's prudential regulator for deposit-takers (banks, building societies and credit unions), insurers and designated investment firms.<sup>(1)</sup> It derives its responsibilities and its powers from the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) (the Act), and the relevant EU Directives for which it is a competent authority.<sup>(2)</sup> It also has responsibility for the supervision of compliance with directly applicable EU regulations.

2. This paper sets out how the PRA carries out its role in respect of deposit-takers and designated investment firms; a second paper relates to supervision of insurance companies.<sup>(3)</sup> Separate publications are necessary to capture the differences in the PRA's supervisory approach for these firms, the different risks they pose, and the additional statutory objective that the PRA has in respect of insurers.

3. This paper serves three purposes. First, it is intended to meet the statutory requirement on the PRA to issue guidance on how it intends to advance its objectives. Second, it aids accountability by describing what the PRA seeks to achieve and how it intends to achieve it. Third, it communicates to regulated firms what the PRA expects of them, and what they can expect from the PRA in the course of supervision.

4. The paper is designed to provide an overall description of the PRA and its approach, acting as a standing reference that will be revised and reissued in response to significant legislative and other developments which result in changes to the PRA's approach.

5. With the exception of the secondary competition objective, the paper does not address the contents of the Financial Services (Banking Reform) Act 2013 or its implications for the PRA.<sup>(4)</sup> This will be covered in a later update.

### Structure of this paper

6. Section I describes the PRA's general statutory objective under the Act, and its approach to advancing that objective. Section II outlines how the PRA determines the focus of its supervision in identifying the key risks to its objective. Section III examines the measures that the PRA expects firms to have in place to ensure their businesses are run in a safe and sound manner, both in guarding against failure and in reducing the adverse effects that their operations could have on financial stability. Section IV sets out more detail on the PRA's supervisory approach. Section V outlines the PRA's approach to setting and communicating expectations of firms.

(1) Most investment firms are prudentially regulated by the FCA. However, the PRA regulates a small number that could present significant risks to the stability of the financial system. The PRA's statement of policy on the designation of investment firms is available at [www.bankofengland.co.uk/publications/Documents/other/pradesignationofinvestmentfirms.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pradesignationofinvestmentfirms.pdf).

(2) Specifically the Capital Requirements Directive, the Financial Conglomerates Directive, the Markets in Financial Instruments Directive and the Deposit Guarantee Schemes Directive.

(3) [www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf).

(4) As outlined by HM Treasury in its White Paper, *Banking reform: delivering stability and supporting a sustainable economy*, available at [www.hm-treasury.gov.uk/d/whitepaper\\_banking\\_reform\\_140512.pdf](http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf).

## I The PRA's approach to advancing its general objective

### Summary

7. The PRA has a general objective to **promote the safety and soundness of firms**, and within this it **focuses primarily on the harm that they can cause to the stability of the UK financial system**. A stable financial system, that is resilient in providing the supply of critical economic functions the economy needs, is a necessary condition for a healthy and successful economy, as demonstrated by the costs imposed by the recent financial crisis on society at large.

8. Consistent with the Act, **it is not the PRA's role to ensure that no firm fails**. Rather, the PRA seeks to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical economic functions. Nevertheless, failure is not costless and there is inherent uncertainty about whether a firm can fail without damaging the system. Consequently, the PRA expects a given level of resilience against failure from all firms.

9. To advance its general objective, the PRA sets out policies which it expects firms to meet both in letter and in spirit; and it supervises firms to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, taking action if they do not.

### The PRA's primary general objective

10. Under the Act, the PRA has a primary statutory objective to promote the safety and soundness of the firms it regulates. In addition to this general objective, the PRA has a second objective specific to its regulation of insurers: to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders. This second objective is discussed in the parallel document for insurance.

11. The Act requires the PRA to advance its general objective primarily by:

- seeking to ensure that the business of the firms it regulates is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- seeking to minimise the adverse effect that the failure of one of the firms it regulates could be expected to have on the stability of the UK financial system.

12. **The PRA is thus tasked with promoting the safety and soundness of all the firms it regulates and is entitled to prioritise its resources on those firms with the greatest potential to affect financial stability adversely, whether through failing or through the way in which they carry on their business.**

### Safety and soundness

13. 'Safety and soundness' involves firms having resilience against failure now and in the future, and avoiding harm resulting from the disruption to the continuity of financial services, either in the course of business or in the event of failure. In discharging its general objective, the PRA will focus, in particular, on the risk of disruption to the continuity of critical economic functions. This is because a stable financial system, that is resilient in providing the supply of critical economic functions the economy needs, is a necessary condition for a healthy and successful economy.

14. The Act includes 'Threshold Conditions', which set out the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage. The Threshold Conditions for which the PRA is responsible are designed to promote safety and soundness. At a high level, the Threshold Conditions require (see Box 1):

- a firm's head office, and in particular its mind and management, to be in the United Kingdom if it is incorporated in the United Kingdom;
- a firm's business to be conducted in a prudent manner — and in particular that the firm maintains appropriate financial and non-financial resources;
- the firm itself to be fit and proper and be appropriately staffed; and
- the firm and its group to be capable of being effectively supervised.

15. Firms should themselves ensure that they meet the Threshold Conditions at all times. The PRA assesses firms against them on a continuous basis. The PRA has made Fundamental Rules (see Box 2), which set out at a high level, the requirements placed on firms. These are supported by more detailed rules and directly applicable EU regulations. **A firm must comply with these requirements and must understand what they mean for its business.** A failure to comply with the Fundamental Rules may be relevant to a firm's ongoing compliance with the Threshold Conditions and may result in enforcement or other actions.

### Stability of the system

16. The PRA concentrates on avoiding harm resulting from the disruption to the continuity of financial services. It **aims to avoid developments that impair the capacity of the UK financial system to carry out activities important to the functioning of the economy, in particular the provision of critical economic functions.**<sup>(1)</sup>

(1) As set out in Section 11 of the Act, 'the UK financial system' refers to 'the financial system operating in the United Kingdom and includes — (a) financial markets and exchanges, (b) regulated activities, and (c) other activities connected with financial markets and exchanges'.

17. A firm can adversely affect the stability of the financial system through the way in which it carries on its business in normal times, including if its activities create the possibility of future stress. Firms can contribute to risky behaviour across the system as a whole by competing for business too aggressively; or by taking actions when under stress that may cause problems for others. Or a firm may have systems that are insufficiently resilient to provide services to the economy, or impede the development of system-wide financial infrastructure. **Together with the FCA as conduct regulator, and the FPC as macroprudential authority where appropriate, the PRA aims to reduce such effects.**

18. A firm can also adversely affect the stability of the financial system through failing. Such effects arise through two broad channels:

- **directly, through the impact on real economic activity or on the soundness of other participants and so the provision of financial services to the economy as a whole.** Real economic activity may be directly affected by the cessation of services. And the soundness of other intermediaries may be affected, for example, by interconnected credit exposures, by pressure on financial asset prices from fire sales following liquidation or mass close-out of positions, or via claims on the deposit guarantee scheme managed by the Financial Services Compensation Scheme (FSCS); and
- **indirectly, through behavioural effects where vulnerabilities within one firm affect confidence in other firms with similar business models or products.** This is of particular concern for deposit-takers, given their role in providing maturity transformation of deposits and other short-term liabilities into longer-term assets, and the resultant risk of contagion following firm failure.

19. Promoting financial stability includes protecting depositors' ability to make payments. It does not include preventing direct losses to depositors or other creditors, except where they could lead to the impairment of the financial system as described above. Ensuring that depositors retain access to their funds in the event of firm failure, either through a transfer of their accounts to a different institution, or by compensation through a FSCS payout of the protected element of eligible deposits, is an important means of minimising such effects.

### Firm failure

20. As recognised in the Act, it is not the PRA's role to ensure that no firm fails. It is thus a key principle underlying the PRA's approach that it does not seek to operate a zero-failure regime. Rather, the PRA seeks — as far as possible within the resolution regime in place — to ensure that any firms that fail do so in a way that enables continuity of

supply of critical economic functions necessary to maintain financial stability and confidence in the financial system. Considering the impact of firm failure, and acting pre-emptively to ensure either recovery or orderly closure, is a core aspect of the PRA's approach. Ensuring all firms regulated by the PRA have a feasible and credible resolution plan is a key objective of the Bank, and the PRA works to deliver this through its supervisory strategy in light of the resolution regime in place.

21. That firms should be allowed to fail so long as failure is orderly — that is, so long as a continuity of access to the critical economic functions of a failing firm is preserved or wound down in an orderly manner (including by transfer to another firm) — reflects the view that firms should be allowed to fail, and thereby subject to the disciplines of the market. It is important for firms to be able to fail in an orderly way without public funds being put at risk since, apart from being an unwarranted subsidy, the public provision of solvency support to a firm (or its creditors) can create an expectation of future assistance. This 'moral hazard' in turn increases the risk of future financial instability, as it provides incentives for excessive risk-taking and reduces market discipline.

22. Although it is not the PRA's role to ensure that no firm fails, under the PRA's prudential regulatory regime, **firms must maintain a certain level of resilience against failure.** Failure is not costless. And, while failure of an individual firm is a feature of a properly functioning market, it is essential for the PRA to ensure confidence in general in the resilience of the firms that it supervises in order for it to deliver on its objective.

### Investigations into regulatory failure

23. The Financial Services Act 2012 requires the PRA to investigate and report to HM Treasury on events which indicate possible regulatory failure. The PRA has set out, in a published policy statement, how it will judge whether and when such failures have occurred. Consistent with its statutory objectives, the PRA is clear that firm failures will not automatically indicate regulatory failure.<sup>(1)</sup>

### The PRA's approach to advancing its objective

24. The PRA supervises a large number of very diverse deposit-takers, whose contribution to, and potential impact on, the UK economy is significant.

25. In total the PRA supervises around 900 financial groups containing deposit-takers. These contain some 240 banks, 50 building societies and 600 credit unions, as well as a small number of designated investment firms that have the potential to present significant risk to the stability of the financial system.

(1) The statement of policy on conducting statutory investigations is available at [www.bankofengland.co.uk/publications/Documents/other/pr/conductstatinvestigations.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pr/conductstatinvestigations.pdf).

## Box 1

### The PRA's Threshold Conditions

The Threshold Conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage. PRA-authorized firms need to meet both the PRA-specific and FCA-specific Threshold Conditions. This box reproduces the PRA-specific Threshold Conditions that apply for banks, building societies, credit unions and designated investment firms.<sup>(1)</sup>

In this extract —

'assets' includes contingent assets;  
 'consolidated supervision' has the same meaning as in section 3M of the Act;  
 'functions', in relation to the PRA, means functions conferred on the PRA by or under the Act;  
 'liabilities' includes contingent liabilities;  
 'relevant directives' has the same meaning as in section 3M of the Act;  
 'subsidiary undertaking' includes all the instances mentioned in Article 1(1) and (2) of the Seventh Company Law Directive in which an entity may be a subsidiary of an undertaking.

For the purposes of this extract, the 'non-financial resources' of a person include any systems, controls, plans or policies that the person maintains, any information that the person holds and the human resources that the person has available.

References to the failure of a person are to be read in accordance with section 2J(3) and (4) of the Act (which indicate that failure includes a firm entering into any one of a range of insolvency events, the use of stabilisation powers under the Banking Act 2009 in relation to that firm, or that firm being unable or likely to be unable to satisfy claims against it).

#### Introduction

5A. If the person concerned ('D') carries on, or is seeking to carry on, PRA-regulated activities which do not consist of or include a regulated activity relating to —

- (a) the effecting or carrying out of contracts of insurance,
- (b) managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's, or
- (c) arranging, by the Society, of deals in contracts of insurance written at Lloyd's,

the threshold conditions which are relevant to the discharge by the PRA of its functions in relation to D are the conditions set out in paragraphs 5B to 5F.

#### Legal status

5B. If D carries on or is seeking to carry on a regulated activity which consists of or includes accepting deposits or issuing electronic money, D must be —

- (a) a body corporate, or
- (b) a partnership.

#### Location of offices

5C. (1) If D is a body corporate incorporated in the United Kingdom —

- (a) D's head office, and
- (b) if D has a registered office, that office, must be in the United Kingdom.

(2) If D is not a body corporate but D's head office is in the United Kingdom, D must carry on business in the United Kingdom.

#### Business to be conducted in a prudent manner

5D. (1) The business of D must be conducted in a prudent manner.

(2) To satisfy the condition in sub-paragraph (1), D must in particular have appropriate financial and non-financial resources.

(3) To have appropriate financial resources D must satisfy the following conditions —

- (a) D's assets must be appropriate given D's liabilities, and
- (b) the liquidity of D's resources must be appropriate given D's liabilities and when they fall due or may fall due.

(4) To have appropriate non-financial resources D must satisfy the following conditions —

- (a) D must be willing and able to value D's assets and liabilities appropriately,
  - (b) D must have resources to identify, monitor, measure and take action to remove or reduce risks to the safety and soundness of D,
  - (c) D must have resources to identify, monitor, measure and take action to remove or reduce risks to the accuracy of D's valuation of D's assets and liabilities,
  - (d) the effectiveness with which D's business is managed must meet a reasonable standard of effectiveness, and
  - (e) D's non-financial resources must be sufficient to enable D to comply with —
    - (i) requirements imposed or likely to be imposed on D by the PRA in the exercise of its functions, and
    - (ii) any other requirement in relation to whose contravention the PRA would be the appropriate regulator for the purpose of any provision of Part 14 of the Act.
- (5) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) or (2) include —
- (a) the nature (including the complexity) of the regulated activities that D carries on or seeks to carry on;
  - (b) the nature and scale of the business carried on or to be carried on by D;
  - (c) the risks to the continuity of the services provided or to be provided by D;
  - (d) the effect that the carrying on of the business carried on or to be carried on by D might be expected to have on the stability of the UK financial system;
  - (e) the effect that D's failure might be expected to have on the stability of the UK financial system;
  - (f) D's membership of a group and any effect which that membership may have.

#### Suitability

5E. (1) D must be a fit and proper person, having regard to the PRA's objectives.

(2) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) include —

- (a) whether D has complied and is complying with requirements imposed by the PRA in the exercise of its functions, or requests made by the PRA relating to the provision of information to the PRA and, if D has so complied or is so complying, the manner of that compliance;
- (b) whether those who manage D's affairs have adequate skills and experience and have acted and may be expected to act with probity.

#### Effective supervision

5F. (1) D must be capable of being effectively supervised by the PRA.

(2) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) include —

- (a) the nature (including the complexity) of the regulated activities that D carries on or seeks to carry on;
- (b) the complexity of any products that D provides or will provide in carrying on those activities;
- (c) the way in which D's business is organised;
- (d) if D is a member of a group, whether membership of the group is likely to prevent the PRA's effective supervision of D;
- (e) whether D is subject to consolidated supervision required under any of the relevant directives;
- (f) if D has close links with another person ("CL") —
  - (i) the nature of the relationship between D and CL,
  - (ii) whether those links are or that relationship is likely to prevent the PRA's effective supervision of D, and
  - (iii) if CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State ("the foreign provisions"), whether those foreign provisions, or any deficiency in their enforcement, would prevent the PRA's effective supervision of D.

(3) D has close links with CL if —

- (a) CL is a parent undertaking of D,
- (b) CL is a subsidiary undertaking of D,
- (c) CL is a parent undertaking of a subsidiary undertaking of D,
- (d) CL is a subsidiary undertaking of a parent undertaking of D,
- (e) CL owns or controls 20% or more of the voting rights or capital of D, or
- (f) D owns or controls 20% or more of the voting rights or capital of CL.

(1) The full Threshold Conditions Order can be found at [www.legislation.gov.uk/ukSI/2013/555/contents/made](http://www.legislation.gov.uk/ukSI/2013/555/contents/made).

## Box 2

### The PRA's Fundamental Rules

Firms must ensure they are compliant with all applicable PRA rules and directly applicable EU regulations, including the Fundamental Rules,<sup>(1)</sup> as set out in the PRA Rulebook. The Fundamental Rules require firms to act in accordance with 'safety and soundness' by setting specific high-level requirements on them, namely:

- **Fundamental Rule 1:** A firm must conduct its business with integrity.
- **Fundamental Rule 2:** A firm must conduct its business with due skill, care and diligence.
- **Fundamental Rule 3:** A firm must act in a prudent manner.
- **Fundamental Rule 4:** A firm must at all times maintain adequate financial resources.
- **Fundamental Rule 5:** A firm must have in place effective risk strategies and risk management systems.
- **Fundamental Rule 6:** A firm must organise and control its affairs responsibly and effectively.
- **Fundamental Rule 7:** A firm must deal with its regulators in an open and co-operative way, and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice.
- **Fundamental Rule 8:** A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

(1) For the policy statement outlining the Fundamental Rules, see [www.bankofengland.co.uk/pr/Pages/publications/ps/2014/ps514.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ps/2014/ps514.aspx).

26. It supervises a handful of very large UK-headquartered firms that are both systemically important financial institutions globally and significant to the stability of the financial system domestically. And it supervises many hundreds of credit unions, the majority of which operate in a particular locality. It supervises both mutuals and shareholder-owned firms.

27. The PRA supervises UK-headquartered as well as international firms from around 60 countries. The legal structures it is responsible for supervising include passported branches from within the European Economic Area (EEA), branches from other countries and UK-owned subsidiaries of international firms, including some that are systemically relevant in their own right.

28. Some prudential issues are common to all these firms. They generally undertake maturity transformation and are levered, leaving them inherently vulnerable to a loss of confidence. This underlies the PRA's objective to promote their safety and soundness — so that they are financially sound, and run in a prudent manner — which the PRA advances by setting out policies that firms should meet in spirit as well as to the letter.

29. The PRA supervises firms to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, and will take action where needed to restore safety and soundness. Recognising the wide diversity in regulated firms, the PRA tailors its supervision to their particular businesses.

30. The PRA's policies and supervisory approach are designed to advance its objectives. In designing them, the PRA has regard to a number of 'regulatory principles' set out in the Act. These cover: efficiency; proportionality; the desirability of sustainable UK economic growth; senior management responsibility in firms; recognising differences in the nature and objectives of authorised persons; transparency; disclosure of information relating to persons on whom requirements are imposed by or under the Act; and the general principle of consumers taking responsibility for their decisions.

31. The secondary competition objective for the PRA came into force on 1 March 2014, replacing the regulatory principle to have regard to the need to minimise adverse effects on competition. The PRA is undertaking a programme of work to ensure that this new objective is reflected in its decision-making. It is also taking forward projects reviewing parts of the prudential framework enabling it to consider changes to its approach that might further its competition objective without undermining the general objective.

32. The PRA's approach is necessarily determined in an international context. Banking is an international industry, with firms supervised on a co-operative international basis and the prudential policy framework for supervision to a large extent agreed internationally. Given the international nature of UK banking, effective international co-operation, in relation to individual firms and general policy, is essential to the PRA's success.

### The PRA's expectations of firms — policies

33. **Advancement of the PRA's objective ultimately relies on firms conducting their businesses in a safe and sound manner.** This often requires firms to act more prudently than they would otherwise choose, in the presence of incentives to take more risk, and thus to impose more risk on the stability of the financial system, than is in the public interest. Countering this tendency is the primary role of a prudential regulator (see Box 3).

34. The criteria against which firms' safety and soundness is assessed are rooted in the PRA's general statutory objective, the statutory Threshold Conditions for authorisation, and UK and EU law. The Threshold Conditions require firms to: have an appropriate amount and quality of capital and liquidity; have appropriate resources to measure, monitor and manage risk; be fit and proper; and conduct their business prudently.

### Box 3

## Underlying economic justification for prudential regulation

It is likely that, in the absence of prudential regulation, deposit-takers and investment firms would take more risk and be less safe and sound, with the financial system as a whole in consequence less stable, than is in the public interest. This box explains the key factors which account for this, and which prudential regulation aims to counter.

Because of the typically liquid nature of their liabilities, it is possible for deposit-takers, and to some extent investment firms, to be subject to 'runs', even if they are solvent (with their assets worth more than their liabilities). This destroys economic value. Deposit guarantees and central bank liquidity insurance exist to address this problem. But they in turn reduce the incentives for firms to manage their business in a prudent manner ('moral hazard'), creating the potential for excessive risk-taking. Prudential regulation can help to address this.

Prudential regulation is also necessary to address the risks that deposit-takers and investment firms can pose more widely to the stability of the system. The failure of deposit-takers can disrupt the payment system and so depositors' ability to undertake economic activity. And some of the lending provided by banks (for example to small and medium-sized companies) may be difficult to substitute via the capital markets, meaning that bank failures or financial weakness can severely affect the supply of credit to the economy as a whole.

Compounding this, deposit-takers and investment firms are also more vulnerable to failure than other types of firm. They tend to be more interconnected, for example through credit exposures, than other types of firm, increasing the risk that the failure of one institution will lead to the failure of others. And the failure of one firm can also affect confidence in others with similar business models, triggering runs as described above.

At an individual level, firms have no incentive to take into account such system-wide effects, but collectively they share an interest in a stable financial system. They thus face a 'collective action' problem. And, crucially, the risk that the failure of a firm could cause wider disruption to the financial system underpins expectations of the state providing solvency support to them. This moral hazard again compounds incentives for excessive risk-taking and reduces market discipline. Prudential regulation can help to address these problems.

Another factor which can contribute to firms being less safe and sound and the financial system less stable than is in the

public interest is that it can be difficult for the owners of a deposit-taker or investment firm to control the firm effectively. This problem exists for all firms where ownership and control are separate, but is particularly acute for financial firms because of the opacity of the value of their assets and liabilities. Compounding this, it is difficult for owners (who can be a diverse and numerous set of shareholders or members) to co-ordinate themselves to acquire the information that they would need to monitor management's activities more effectively. Managers can have their own objectives, different to those of the firm's owners, and this may result in them taking excessive risk, for example through pursuing growth in the interests of short-term reward. A further problem can exist between senior management and individual risk-takers (such as traders); with the latter having incentives to take excessive risk outside the formal control structures of the firm.

In addition, when a firm is owned by private shareholders whose stake is leveraged through borrowing from depositors and other creditors, the owners will tend to have an incentive to take on more risk than is in the interests of the firm's creditors. That is because shareholders, although the first bearers of loss, typically have limited liability in the event of failure but enjoy the unlimited upside associated with successful risk-taking. So maximising the expected return on equity in the interests of shareholders will tend to mean taking on more risk than is in the interests of creditors, particularly given shortcomings in creditors' ability and incentives to exert discipline over firms or expectations of state solvency support.

35. The PRA has set out clearly, including in this document, the criteria against which it judges the safety and soundness of firms, so that firms can understand what the PRA expects. This paper sets out high-level policies that elaborate on the Threshold Conditions and which are supported in many cases by more detailed material published by the PRA and directly applicable regulations set at EU level. Firms should refer to these also for further elaboration on what is expected of them.

36. In general, the PRA at the outset inherited the prudential aspects of the Financial Services Authority's (FSA's) *Handbook* and certain relevant policy materials. However, in light of its statutory objectives and the Threshold Conditions, and as explained in this document, in assessing firms the PRA places greater emphasis on certain criteria than was the case with the FSA. In addition, in some specific cases, this document sets out new expectations which have not previously been expressed formally to firms. Over time, the PRA will continue to substantially amend and streamline the current *PRA Handbook*, and the associated materials carried over from the FSA, creating a new *PRA Rulebook* and body of supporting supervisory statements.

37. Rules set out some of the requirements that a firm must meet in order for its business to be conducted in a safe and sound manner. But the PRA expects firms not merely to meet the letter of the requirements, nor indeed to game them by engaging in 'creative' compliance or regulatory arbitrage designed to mask the riskiness of activities or business models. Rather, firms should maintain sight of the overriding principle of their safety and soundness and act accordingly. Support for this objective should be embedded in every firm's culture. So that there are no ambiguities about its intended outcomes, the PRA has set out, in this document and elsewhere, the purpose and principles of its approach.

**The PRA's approach to supervision**

38. The PRA supervises firms to judge whether they are acting in a safe and sound manner, and so whether they meet, and are likely to continue to meet, the Threshold Conditions.

39. The PRA weights its supervision towards those issues and those firms that, in its judgement, pose the greatest risk to the stability of the UK financial system. The frequency and intensity of the supervision experienced by firms thus increases in line with the risks they pose. The PRA aims always to focus on material issues when engaging with firms.

40. The PRA is forward looking, assessing safety and soundness not just against current risks, but also against those that could plausibly arise further ahead. And where the PRA judges it necessary to intervene to mitigate the risks a firm is creating, it seeks to do so at an early stage. To support this, firms should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

41. The PRA's approach relies significantly on judgement. Supervisors reach judgements on the risks that a firm is running; the risks that it poses to the PRA's objective; whether the firm is likely to continue to meet the Threshold Conditions; and how to address any problems or shortcomings identified. And, in particular, supervisors need to decide which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward-looking regime, where the future state of the world is inherently uncertain. Use of judgement is also necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes.

42. The PRA's supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the institution. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong.

43. In order to minimise such outcomes, the PRA needs to be staffed by people with strong, relevant skills and experience (see Box 9), and its major judgements and decisions involve the PRA's most senior and experienced staff and directors. The PRA engages with the boards and senior management of firms

Figure 1 The PRA's risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Capital	Liquidity	Resolvability

## Box 4

### Working with other authorities

Co-ordination with other authorities is essential to the PRA's success. This box outlines the PRA's approach to interaction with these other bodies.

#### Bank of England and FPC

The PRA is a part of the Bank of England, and is therefore connected to the Bank's other functions — including its role as lender of last resort, and its work on market intelligence, oversight of financial market infrastructure, prudential policy, financial sector resilience and the exercise of resolution powers. This facilitates the flow of information between these functions.

The PRA's objective of promoting the safety and soundness of firms, focusing primarily on the harm that they can cause to the UK financial system, complements the Bank's wider objective of 'promoting the good of the people of the United Kingdom by maintaining monetary and financial stability'. And the PRA's focus on minimising the adverse effects of firm failure complements the special resolution objectives under the Banking Act 2009 which the Bank, as Special Resolution Authority, shares with other authorities.

An effective regulatory framework for financial stability also needs to combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA therefore works closely with the FPC, within the Bank, which has statutory responsibility for reducing risks to the financial system as a whole.

The FPC can make recommendations and give directions to the PRA on specific actions that should be taken in order to achieve the FPC's objectives. The PRA is responsible for responding to FPC recommendations, which may be made on a 'comply or explain' basis, and for complying with the FPC's directions in relation to the use of macroprudential tools, specified by HM Treasury in secondary legislation.<sup>(1)</sup> The PRA reports to the FPC on its delivery of these recommendations and directions.

There is a frequent two-way flow of information and exchange of views between the PRA and the FPC. The PRA provides firm-specific information to the FPC, to assist its macroprudential supervision. And the FPC's assessment of systemic risks influences the PRA's judgements in pursuit of its own objective.

Co-ordination between the PRA and the FPC is assisted by the common membership of the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Deputy Governor for Markets and Banking,<sup>(2)</sup> and the Chief Executive Officer (CEO) of the PRA on both the PRA Board and the FPC.

#### FCA

The FCA acts as conduct regulator for the firms prudentially regulated by the PRA. The PRA has a statutory duty to co-ordinate with the FCA in the exercise of its public functions, including policymaking and supervision. A Memorandum of Understanding (MoU) between the FCA and the PRA describes how the two regulators fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives.<sup>(3)</sup>

A key principle for this co-operation, given the regulators' separate mandates for prudential and conduct regulation of PRA-licensed firms, is that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other.

The MoU details a number of areas where the PRA and the FCA co-operates:

- **Sharing of information:** both regulators will share information in a 'timely and focused manner' for delivering effective supervision. This will include in making sure, where possible, that request for regulatory data is not duplicated. Although emphasis will be given in protecting the confidentiality of firms where relevant.
- **Policy and rule-making:** the PRA and the FCA will consult with each other early if any of their policies or rules might have a material effect on the other's objectives.
- **Authorisation of firms and approval of individuals:** the PRA and the FCA will co-operate on all authorisations and approval cases through a process of 'consult and consent'.
- **Supervision of dual-regulated firms:** the regulators are not required to conduct supervision jointly, but each will share information to reflect adequate supervisory judgement.
- **Overseas firms:** both regulators will reflect adequate supervision for international firms through co-operation at colleges and various EEA forums.

Co-ordination between the PRA and the FCA is assisted by the membership of their CEOs on each other's board. This cross-board role focuses on areas of overlap and discussions of material relevance to each CEO's own organisation. Co-ordination between the organisations is also assisted by common membership of their CEOs on the FPC.

The PRA and the FCA are also party to other MoUs with the Bank as a whole and HM Treasury on international engagement, and the rest of the Bank on the oversight of financial market infrastructure.

#### Financial Services Compensation Scheme Ltd (FSCS)

The FSCS is the United Kingdom's compensation fund of last resort for customers of authorised financial services firms. It may pay compensation to eligible claimants if a firm is unable,



or likely to be unable to pay claims against it. The MoU between the PRA and the FSCS details how the two authorities co-operate and co-ordinate.<sup>(4)</sup>

The PRA works closely with FSCS colleagues in order to assess and enhance the resolution framework for deposit-takers in order to discharge its primary objective. The FSCS supports the PRA's assessment of a firm's resolvability and likelihood that any failure would be orderly. The PRA will seek to ensure that, through the Proactive Intervention Framework, the FSCS has reasonable notice of activity where the PRA may require significant involvement of the FSCS.

### Other UK bodies

The PRA often needs to work with other UK regulators, either to pursue its own objective or to assist them in theirs; this may also include other enforcement agencies.

The PRA has agreements to support the sharing of information and judgements, and the co-ordination of actions. The PRA's general approach to these arrangements and the relationships they underpin is focused on:

- enabling all parties to focus on their own objectives;
- the substantive issues of potential co-ordination;
- avoiding where possible a detailed, prescriptive approach, to ensure that judgement and flexibility are not lost; and
- provisions for regular review, ensuring that MoUs remain current and embedded within the organisations.

### International co-operation

Banking is an international industry. Many UK firms have operations overseas, and many firms domiciled overseas

have subsidiaries or branches in the United Kingdom. Deposit-takers and investment firms are therefore supervised on a co-operative international basis, and the policy framework for this supervision is to a large extent agreed globally, including by the Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB), to ensure that all jurisdictions uphold appropriate standards in their collective interest.

The PRA participates actively in global and European supervisory fora, playing a full and active role with its counterparts in supervising cross-border firms, and seeking to be an influential and persuasive participant in international policy debates. In particular, the PRA actively participates in the work of the FSB and the BCBS. And it aims to influence and reflect in its approach the work of the European System of Financial Supervision, of which it is a part.

The approach to supervision set out in this document implements the PRA's international obligations and commitments, including the Basel Committee's *Core Principles for Effective Banking Supervision* and its *Concordat on consolidated supervision* and subsequent publications on international supervisory co-ordination.

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- (1) See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at [www.hm-treasury.gov.uk/press\\_83\\_12.htm](http://www.hm-treasury.gov.uk/press_83_12.htm).
- (2) The addition of the Deputy Governor for Markets and Banking to the PRA's Board and to the FPC was announced by the Chancellor and the Governor as part of the Bank's Strategic Review. For more information, see [www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments](http://www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments).
- (3) See the Memorandum of Understanding available at [www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf](http://www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf).
- (4) For more information on the MoU between the PRA and the FSCS, see [www.bankofengland.co.uk/about/Documents/mous/moufscspra.pdf](http://www.bankofengland.co.uk/about/Documents/mous/moufscspra.pdf).

in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements and to communicate clearly the rationale for them. Firms should not, however, approach their relationship with the PRA as a negotiation.

44. The PRA will ensure that it recognises promptly when its concerns appear subsequently to be unjustified, and so when its actions need to be adjusted.

### The PRA's risk framework

45. **The PRA takes a structured approach when forming its judgements.** The framework used, which is illustrated in **Figure 1**, captures three key elements:

- the *potential impact* that a firm could have on financial stability, both by the way it carries on its business and in the event of failure (as described in paragraphs 16–19 above);
- how the external context in which a firm operates and the business risks it faces (together, its *risk context*) might affect the viability of the firm; and

- *mitigating factors* including: a firm's management and governance and its risk management and controls (operational mitigation); its financial strength, specifically capital and liquidity (financial mitigation); and its resolvability (structural mitigation).

46. **The intensity of the PRA's supervisory activity varies across firms.** The level of supervision principally reflects the PRA's judgement of a firm's potential impact on the stability of the financial system; its proximity to failure (as encapsulated in the Proactive Intervention Framework, which is described below); and its resolvability. Other factors, including the complexity of the firm's business and organisation, also play a part.

47. The following sections: examine in more detail the individual elements of this risk framework; describe the work the PRA does to support its judgements; and set out what the PRA expects of firms in these areas. Box 4 sets out how the PRA interacts with other authorities both domestically and internationally in support of its approach.

## II Identifying risks to safety and soundness

48. The PRA's approach relies on supervisors understanding the significance of individual firms to the stability of the UK financial system, the nature of the firm's business and the wider economic environment, and the potential risks to the PRA's objective that, together, these entail. This section describes how the PRA assesses these factors.

### Potential impact

49. As a core part of its work, **the PRA assesses the significance of a firm to the stability of the UK financial system.** This 'potential impact' reflects a firm's potential to affect adversely the stability of the system by failing, coming under stress, or the way it carries on its business. **The PRA's assessment:**

- helps to **determine the intensity of supervision for a firm;** and
- **helps to focus the supervisory strategy,** by identifying particular areas where a firm provides critical economic functions, and so highlighting likely sources of significant risk to the PRA's objective.

50. As described in paragraphs 16–19, the potential for a firm adversely to affect the stability of the financial system depends both on the functions it provides and its significance within the system. Some of the critical economic functions that firms provide are: payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; and custody services. The scale of a firm's potential impact depends on its size, complexity, business type and interconnectedness with the rest of the system.

51. The PRA divides all deposit-takers, designated investment firms and insurers into the five 'categories' of impact below:

#### Category 1

- The most significant deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- Insurers whose size (including number of policyholders) and type of business mean that there is very significant capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 2

- Significant deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and

business type give them the capacity to cause some disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

- Insurers whose size (including number of policyholders) and type of business mean that there is significant capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 3

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, and where difficulties across a whole sector or subsector have the potential to generate disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is minor capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 4

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them very little capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is very little capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 5

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector may have the potential to generate some disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is no capacity to cause disruption to the interests of a substantial number of policyholders.

52. The PRA also considers the substitutability of the services that the firm provides, and the extent to which this could mitigate the impact of failure. It is mindful that the extent to

which this is possible may differ in benign and stressed circumstances.

53. The PRA uses quantitative and qualitative analysis to allocate firms to categories. Numerical scoring based on firms' regulatory reporting provides a 'suggested' categorisation, which supervisors review in light of qualitative analysis to confirm that it presents a full picture of a firm's potential impact.

54. Firms are told to which category they have been assigned, providing a broad indication of what level of supervisory interaction to expect. The PRA will publish aggregate statistics on the number of firms in each category in its *Annual Report*.

## External context

55. **Any assessment of the risks facing firms requires an appreciation of the external context in which they operate.** The PRA's assessment therefore includes consideration of system-wide risks, for example from low interest rates, excess credit growth or international imbalances, and sectoral risks, for example in commercial real estate.

56. The PRA draws on work by other parts of the Bank, including the views of the FPC on the macroprudential environment. Sectoral analysis to understand key market developments over the medium term draws upon both market intelligence and, where appropriate, standardised information from firms.<sup>(1)</sup> The PRA also considers actions by other regulators, including the FCA, that might materially affect the prudential soundness of PRA-authorized firms.

## Business risk

57. **Business model analysis forms an important part of the PRA's supervisory approach.** The PRA examines the threats to the viability of a firm's business model, and the ways in which a firm could create adverse effects on other participants in the system by the way it carries on its business. The analysis includes an assessment of where and how a firm makes money, the risks it takes in so doing, and how it funds itself. Firms are assessed at the level of the firm or the sector as appropriate.

58. The PRA aims to understand a business model's sustainability and vulnerabilities. Vulnerabilities might include: unsustainable expectations of growth; heavy reliance on an inflexible structure of net interest income, with consequent exposure to a low interest rate environment; concentrated funding sources which may dry up in stressed circumstances; or significant consequences following a change

in credit rating. The PRA uses this work to focus its supervisory activity.

59. For those firms posing greater risk to the stability of the system, the analysis is more detailed. It includes a review of the drivers of profitability, risk appetite, performance targets and underlying assumptions, and a firm's own forecasts and their plausibility. The PRA uses this analysis to form a projection of the firm's ability to generate returns and the associated risk and funding profile over the medium term. This projection and the general picture supervisors form of the nature of the business guide the PRA's work in assessing the adequacy of the measures the firm has in place to mitigate risk. For example, the PRA's forward-looking view of the firm's prospects informs its judgement on the level of capital a firm requires; and the complexity of the firm's business informs judgements about that firm's risk management procedures. If the PRA believes that mitigating measures alone cannot adequately reduce material risks to the safety and soundness of the firm, the firm will be required to change its business model.

60. **Peer analysis forms an important part of this assessment,** providing a diagnostic tool to highlight where individual institutions may be outliers relative to their sector and so in need of further analysis. Such analysis also supports an understanding of common sectoral risks that have the potential to affect the stability of the system, on which the PRA involves the FPC.

61. **The PRA's assessment of business risk also includes an assessment of whether the PRA can effectively supervise the activities that a firm carries out** — whether it is possible, with a reasonable amount of effort, for the PRA to form a clear view of the risks posed to the safety and soundness of the firm. Where a firm's business is particularly complex, the PRA considers whether it is possible to evaluate effectively the prudential risks to the firm arising from it.<sup>(2)</sup> Where the PRA identifies material barriers to effective supervision, remedial action will be required.

62. Other key attributes that determine whether a firm is capable of being effectively supervised are the organisational structure of its group and its ability to provide sufficient information to the PRA. For example, for firms with operations overseas the PRA examines the local legal and regulatory regimes in the relevant jurisdictions, particularly where any features of those regimes are not equivalent to UK standards, or are likely to affect the quality or flow of information to the PRA. The criteria for assessing whether a firm can be

(1) That is, information reported in a pre-agreed format by a defined set of firms, using common definitions.

(2) The PRA takes this into account in its assessment of a firm against the 'effective supervision' Threshold Condition, that a firm must be capable of being effectively supervised by the PRA.

supervised effectively are considered further in Section III, in respect of the PRA's expectation of firms around management and governance and risk management and controls, and in Section IV, in respect of the PRA's approach to supervision of international firms (see Box 6).

### III Safeguarding safety and soundness

63. **The PRA assesses whether firms have in place adequate measures to safeguard their safety and soundness, in light of the risks they pose to the PRA's objective.** These mitigating measures include: management and governance, risk management and controls, capital, liquidity and resolvability. This section sets out some of the key criteria against which the PRA assesses the adequacy of these measures. It also outlines some specific supervisory activities that the PRA undertakes to assess them; more general supervisory activities are outlined in the next section.

64. **The PRA expects higher standards of risk mitigation from firms posing greater risks to the stability of the UK financial system.** The forthcoming additional capital buffer for systemically important firms, as agreed as part of Basel III, is an example of this. Similarly, a firm that is highly interconnected or otherwise significant to the financial system may be required to have more effective risk management.

65. Where possible, the PRA takes an integrated view of the elements of mitigation that a firm has in place. This might mean that supervisors may want a firm temporarily to hold additional capital to make up for perceived shortcomings in risk management. Nevertheless, **firms must meet a minimum level of adequacy across all areas** in the long term: high levels of capital cannot act as a long-term substitute for sub-standard management, for example.

66. The PRA expects firms to meet its expectations on both a consolidated basis for groups headquartered in the United Kingdom, for UK subgroups of wider global groups, and at the level of regulated legal entities. A regulated firm's relationships with other entities in the group may affect its prudential soundness, for example through access to capital, intra-group exposures or contagion.

67. As well as setting expectations of firms, the PRA advances its objective by taking action to improve the wider environment within which firms operate. In particular:

- The PRA works with the FCA and the Financial Reporting Council where appropriate to improve the quality and usefulness of information disclosed on firms' safety and soundness. This includes key information on financial risk and accounting judgements, on a consistent basis across firms, and regulatory returns as necessary. Disclosure of such information assists creditors in judging the risk they take in lending to the firm. This in turn improves firms' own incentives to mitigate those risks. As it becomes more feasible for the authorities to allow firms to fail, market discipline should become a more powerful force on firms.

- Making rules for the FSCS in respect of deposits. The existence of deposit guarantees can reduce the risk of 'runs' on firms and therefore of contagion, provided they are widely understood. The design of the scheme, including for example its funding arrangements, its capacity to support firm resolution and the arrangements for publicising the extent of cover under the scheme, are key to reducing risks to financial stability.

## Management and governance

### Overall approach

68. **It is the responsibility of each firm's board and management to manage the firm prudently, consistent with its safety and soundness, thereby contributing to the continued stability of the financial system.** This goes beyond complying with the letter of the PRA's detailed requirements, for example, on adequate capital and liquidity and risk management and controls, and it often means firms acting more prudently than they would otherwise choose. It also goes beyond core responsibilities for all boards and management, such as ensuring that individuals appointed to senior management positions are competent to fill such roles, setting the firm's strategy and policies clearly, and ensuring that these are applied throughout the organisation, with responsibilities clearly apportioned.

69. The boards and management of regulated firms must understand the kind of behaviour that will deliver an acceptable level of safety and soundness from the point of view of the financial system, and act accordingly. This includes following the PRA's policies in line with their spirit and intended outcome — not managing the business only to the letter, or gaming the rules. And it includes embedding the principle of safety and soundness in the culture of the whole organisation. Without such effective, prudent management and governance, it is not possible for firms to ensure their own safety and soundness.

70. For a firm to be permitted to carry out regulated activities, the firm as a whole must be 'fit and proper'. At initial authorisation, the PRA takes into consideration the record of a firm itself where appropriate and those who manage its affairs, including the existence of any record of past misconduct.<sup>(1)</sup>

71. This requirement, for a firm and those managing its affairs to be 'fit and proper', is in addition to the obvious need for a firm's board and senior management, and in particular its Chair, to have regard to the need for the firm to comply with all applicable laws and regulations. These obligations are extensive and not limited to the laws and regulations enforced

(1) This includes the existence of any spent and unspent convictions, regulatory investigations and enquiries, prior refusals of authorisations and/or connections with unsuitable persons.

by the PRA. This is because other laws and regulations — for instance, conformity with tax laws — could affect a firm's fitness and properness, and the probity and reputation of its management.

72. This section elaborates on these broad expectations. In many cases these expectations are directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct', 'suitability' and 'effective supervision' Threshold Conditions. They are broken down into: culture and behaviour, competence and structures.

### Culture and behaviour

73. The PRA expects firms to have a **culture that supports their prudent management**. The PRA does not have any 'right culture' in mind when making its assessment; rather it focuses on whether boards and management clearly understand the circumstances in which the firm's viability would be under question, whether accepted orthodoxies are challenged, and whether action is taken to address risks on a timely basis. The PRA wants to be satisfied in particular that designated risk management and control functions carry real weight within firms.

74. **Individuals, whatever their position in the firm, should take responsibility for acting in a manner consistent with its safety and soundness.**

75. The PRA expects firms to have in place sufficient controls to **minimise incentives for excessive risk-taking** by management and staff. Remuneration and incentive structures should reward careful and prudent management.

76. The PRA expects firms and individuals within them to **deal with the PRA (and other regulators as appropriate) in an open and co-operative manner** as set out in the PRA's Fundamental Rules. That includes taking the initiative to disclose anything relating to the firm, and financial stability more generally, of which the PRA would reasonably expect notice, and providing the PRA with the information it requests on a timely basis. Boards and senior management are expected to ensure that all staff comply with this requirement.

77. The PRA expects a **firm's board to take responsibility for establishing, embedding and maintaining the type of culture described above**. The PRA seeks to address serious failings in the culture of firms as part of its supervisory activities (as outlined in Section IV and Box 7).

78. More generally, **a firm's board should hold management to account for conducting the firm's business in line with the board's expectations**. That should include the board (and its committees) engaging with management to test the robustness and prudence of the assumptions in the business

plan and strategic initiatives, the adequacy and integrity of controls, and the consistency of implementation of the board's decisions. To do this, the board needs to be provided with high-quality management information, both quantitative and qualitative.

79. The PRA considers the **responsibility of board members to be individual, as well as collective**. This means that, should any director have concerns about the firm or its management and governance, the PRA will expect them to press for action to remedy the matter and, if those concerns are not addressed, to alert the PRA. A firm's culture should be encouraging of this.

### Competence

80. Firms must be **run by people who are competent to fill their roles**. That means ensuring that individuals have appropriate expertise and experience, and (in the case of non-executive directors) give sufficient time to fulfil their obligations to a high standard.

81. It is the **responsibility of a firm's board to ensure that individuals appointed to senior management positions are competent** to fill them. As a firm grows and changes, and as the challenges it faces change, it may need different board members and management. The Chair and independent directors should stand ready to have an open exchange of views with the PRA on the performance of senior management, as should the Senior Independent Director on the performance of the Chair.

82. The **board should have a mix and balance of skills so that collectively it can understand the breadth of the business**. The PRA expects many on a firm's board to have expertise in financial services, though this is not a pre-requisite for all members. The PRA expects all board members, either at the outset or after a set period of time, to develop an understanding of the different areas of the business and the main prudential risks and controls and so to be able to engage in an informed conversation with the PRA. The PRA expects more than one independent director to understand major lines of business and risk controls, in order to avoid undue reliance on individuals by the board as a whole.

### Structures

83. The PRA expects firms to have in place **clear structures of accountability and delegation of responsibilities** for individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals should remain accountable for the actions of those to whom they delegate responsibilities, including where firms use third parties in respect of outsourced functions.

84. Within a financial group, **boards and senior management of all authorised entities, including those subject to**

**consolidated supervision, should take responsibility for ensuring that the business is conducted in a prudent manner.** Boards cannot delegate this responsibility.

85. Not all legal entities within groups are necessarily directly authorised by the PRA. Nonetheless, unregulated group entities can be important to the functioning of the group as a whole (for instance, by providing important support services), or can undertake activities which have the potential to create risks for the group as a whole and so for authorised firms. The PRA expects all boards of legal entities within groups, as a result of the responsibilities of their holding companies and their regulated affiliates, to have regard to the PRA's objective. **In cases where the most senior legal entity within a group is a holding company which is not itself authorised under the United Kingdom's statutory regulatory regime, the PRA will expect to have extensive contact with its board and senior management, and will consider whether the holding company is suitable to exercise control over a regulated firm.** The PRA will expect the holding company to take responsibility for the group as a whole having due regard to the PRA's objective. And the PRA will consider whether the regulated firm's membership of a group affects whether the firm satisfies the Threshold Conditions, including whether the ownership structure compromises the ability of the firm to be supervised effectively by the PRA. Further, if the PRA believes that it would be desirable, to advance its objective or for the effectiveness of consolidated supervision, it will exercise the power conferred by the Act to direct the holding company.<sup>(1)</sup>

86. **These requirements on the boards and management of legal entities within groups apply equally to overseas firms** which establish separately incorporated entities within the United Kingdom. In particular, the PRA expects boards and senior management of these firms to have proper regard to the PRA's primary objectives, both for the group as a whole and for individual firms (and subgroups) in the United Kingdom, since issues at the parent or group level could have an effect on the PRA-authorised entity and the PRA's objectives more generally.

87. Firms are able to operate in the United Kingdom as branches of overseas legal entities, meaning that there is no separate legal entity in the United Kingdom. Such branches can take one of two forms: those where the legal entity overseas is located within the EEA; and those located outside the EEA. Regardless of the corporate structure and location of the parent, the PRA expects all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness. The PRA expects the branches to appoint a senior individual with authority to act as a primary contact with the PRA in relation to their affairs. This individual should also act as a channel for communication with the parent. Box 6 sets out how the PRA aims to ensure that its objective is met in respect of overseas firms.

## Supervision — Approved Persons

88. The PRA has the power under the Act to require individuals in identified roles with a significant influence on the affairs of a firm (Significant Influence Function roles) — and who are critical to the advancement of the PRA's objective — to seek PRA approval before taking up their position. Such individuals are known as 'Approved Persons'. Approval is granted only if the PRA as prudential regulator and the FCA as conduct regulator are both satisfied that an individual is fit and proper.

89. PRA Significant Influence Function roles include all members of a firm's board<sup>(2)</sup> and the heads of the finance, risk and internal audit functions. In addition, the PRA may give views to the FCA on applications for an FCA controlled function where the approval, or rejection, of applications to that role may have a material adverse effect on the PRA's advancement of its objective.

90. All individuals applying for the above roles are subject to a basic review of probity, reputation and financial soundness, which may include criminal record and credit checks. The PRA also performs an assessment of an individual's competence and capability to carry out the role. Assessing probity and integrity reduces the risk of behaviour intentionally misaligned with the PRA's objective; assessing competence is necessary given the prime role of these individuals in ensuring the firm's safety and soundness. The nature and intensity of the PRA's assessment depends on the potential impact of the firm.

91. The PRA may interview individuals applying for the above roles. Interviews will include an assessment of the technical experience of the applicant and his or her understanding of the risks posed to the viability of the firm and the risks posed by the firm to the wider financial system. The PRA will assess whether the firm has conducted an appropriately rigorous recruitment process and will take into account the due diligence done by the firm on the applicant.

92. The PRA reviews the fitness and properness of individuals on an ongoing basis, including as part of its supervisory assessment of a firm against the Threshold Conditions.

93. While the PRA's Approved Persons regime applies only to individuals holding certain senior roles, the PRA expects all individuals within a firm to act in a manner consistent with its objective.

(1) The PRA's statement of policy regarding its power of direction over holding companies is available at

[www.bankofengland.co.uk/publications/Documents/other/prapowerdirection.pdf](http://www.bankofengland.co.uk/publications/Documents/other/prapowerdirection.pdf).

(2) Or the equivalent governing body where the firm is not a body corporate.

## Disciplinary action against individuals

94. While the PRA's preference is to use its statutory powers to secure *ex ante*, remedial action, it also has a set of disciplinary powers which it will use *ex post* if necessary.

95. The PRA has disciplinary powers over individuals approved to perform a Significant Influence Function by the PRA or the FCA and is empowered to use these where an individual fails to comply with the *Statement of Principles and Code of Practice for Approved Persons*,<sup>(1)</sup> or has been knowingly involved in a contravention by their firm of a requirement imposed by the PRA. The powers enable the PRA, among other sanctions, to impose financial penalties, to censure an individual publicly, to withdraw approval from individuals holding Significant Influence Functions, and to prohibit individuals from holding Significant Influence Functions in the future.

96. In assessing whether to take disciplinary action against Approved Persons, the PRA considers a variety of factors, including:

- the impact the individual's behaviour has had or is having on the PRA advancing its objective — including the behaviour of other persons in the firm over whom the individual should exercise control — and thus whether that behaviour calls into question the person's fitness and properness as an Approved Person (be it an isolated incident or a course of conduct);
- whether taking action will serve to deter the person who committed the breach, and others who are subject to the PRA's requirements, from committing similar or other breaches; and
- the individual's behaviour towards the PRA, including the level of co-operation and openness with which the individual deals with the PRA and the appropriateness of the individual's actions in response to concerns raised.

## Risk management and controls

### Overall approach

97. The PRA attaches particular importance to firms managing risk effectively, because it is the crystallisation of risk, or concerns about risks crystallising in the future, that causes problems for firms' safety and soundness. **Firms should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business, and consistent with their safety and soundness.** Competent and where appropriate independent control functions should oversee these frameworks.

98. This section sets out the PRA's expectations regarding a firm's approach to risk management, its control framework,

and its risk management and control functions. In many cases these expectations are directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct' and 'effective supervision' Threshold Conditions.

### Risk management approach

99. **The PRA expects firms to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives.** This risk appetite should be consistent with the PRA's objective, and the firm should pay appropriate attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios.

100. The PRA recognises that it is always possible to identify a stress scenario in which a firm fails, and it does not expect firms to be able to withstand all such events. The PRA considers it important, however, for firms' senior management and boards to have an explicit understanding of the circumstances in which their firm might fail.

101. The PRA expects a firm's risk appetite to be integral to its strategy and the foundation of its risk management framework, so that the whole firm operates within this appetite. This requires a **robust risk management framework and its effective and consistent implementation throughout the organisation.** Members of staff in both business and control functions should manage risks as a central part of their role, and responsibility for risk should not be delegated to risk management and control functions. This is a key aspect of a culture (see paragraph 73) which supports the prudent management of the firm.

102. The PRA expects key decisions, both on assuming new risks and managing existing ones, to be taken at the appropriate level, including at the level of the board where they are sufficiently important. Risks should be reported to the board and senior management on a timely basis, with risks outside the agreed risk appetite and key sensitivities highlighted.

### Control framework

103. A firm's control framework encompasses the processes, delegated authorities and limits that put into effect a firm's approach to risk management and control. The PRA expects a **firm's control framework to be comprehensive in its coverage of the whole firm and all classes of risk, commensurate with the nature, scale and complexity of the firm's business, and to deliver a properly controlled operating environment** (including, for example, through segregation of duties, reconciliations or through the process to report and act on any breaches of limits).

(1) Currently within the *PRA Handbook*: <http://fshandbook.info/FS/html/PRA/APER>.



104. The PRA expects firms to observe high standards in the management of operational as well as financial risks. For example, **firms should have procedures in place to ensure continuity of access to critical services.** Firms are expected to comply with standards for resilience set in this area, including where they outsource material operational functions to third parties.

105. The PRA expects **firms to have available the information needed to support their control frameworks.** This information should be of an appropriate quality, integrity and completeness, to provide a reliable basis for making decisions and so to control the business within agreed tolerances. It should be produced in a sufficiently timely manner. And it should be able to be accessed and analysed in aggregate for the business as a whole, across the group, and for each business line and legal entity within it, to facilitate understanding and swift management of the risks to which the firm is exposed. It is also relevant to the Threshold Condition that firms are capable of being supervised effectively by the PRA. The senior management of a firm and the PRA need to be able, with a reasonable amount of effort, to form a clear view of the safety and soundness of the firm, including the financial position of the rest of its group and the risks posed by other individual entities within it.

106. As part of firms' responsibility to have robust information, they should have sight of the likely path of, and risks around, future earnings. It is also important for firms to have processes in place explicitly to assess uncertainties in the valuation of assets and liabilities so as to ensure that material uncertainty is reported to the board and senior management.

107. While quantitative models can play an important role in supporting firms' risk management, the PRA expects firms **to be prudent in their use of such models given the inherent difficulties with risk measurement.** Senior management and the board should therefore understand the extent of reliance on models for managing risk, as well as the limitations arising from the structure and complexity of models, the data used as inputs and underpinning assumptions. Models, and their output, should be subject to effective, ongoing and independent validation to ensure that they are performing as anticipated. The PRA expects senior management to have a clear understanding of the risks that are not adequately captured by the models used, and the alternative risk management processes in place to ensure that such risks are adequately measured and incorporated into the firm's overall risk management framework.

### Risk management and control functions

108. Firms should have in place separate risk management and control functions — notably risk management, finance and internal audit — to the extent warranted by the nature, scale and complexity of their business. The PRA expects these

functions to support and challenge the management of risks firm-wide, by expressing views within the firm on the appropriateness of the level of risk being run and the adequacy and integrity of the associated governance, risk management and financial and other control arrangements.

109. To the extent warranted by the nature, scale and complexity of the business, the PRA expects these functions to be **independent of a firm's revenue-generating functions,** and to possess sufficient authority to offer robust challenge to the business. This requires these functions to be adequately resourced, to have a good understanding of the business, and to be headed by individuals at senior level who are willing and able to voice concerns effectively.

110. An effective **risk management function ensures that material risk issues receive sufficient attention from the firm's senior management and board.**

111. A firm's finance function — which is responsible for the firm's official books and records — **should deliver an accurate understanding of the firm's financial position,** including through the effective challenge of Front Office valuations.

112. Internal audit should provide **independent assurance over firms' internal controls, risk management and governance.** And, in the absence of an internal audit function, there should be a review performed by an independent third party. The PRA worked closely with professional bodies for internal auditors to develop and publish a code that sets out principles for the internal audit function of firms.<sup>(1)</sup>

113. Senior management and the board should hear and heed the views of these functions. This means that they require access to the board and (where a firm has them) the board's Risk and Audit Committees, which should oversee these functions to ensure their independence and effectiveness.

## Capital

### Overall approach

114. **Firms should maintain appropriate capital resources, both in terms of quantity and quality, consistent with their safety and soundness and taking into account the risks to which they are exposed.** Having enough capital of sufficiently high quality reduces the risk of a firm becoming unable to meet the claims of its creditors, and is therefore crucial for maintaining their confidence, which is particularly important for deposit-takers and investment firms given their liabilities are of shorter maturity than their assets. In addition, where a firm is owned by private shareholders, having more shareholder equity — the highest-quality form of capital — gives owners a greater interest in the firm being run prudently.

(1) For more information on the internal audit code, see [www.iaa.org.uk/media/354788/0758\\_effective\\_internal\\_audit\\_financial\\_webfinal.pdf](http://www.iaa.org.uk/media/354788/0758_effective_internal_audit_financial_webfinal.pdf).

115. **As with all elements of its approach, the PRA expects firms in the first instance to take responsibility for ensuring that the capital they have is adequate.** But reflecting the incentives firms have to run their business in a less prudent manner than the public interest would indicate, there is also a clear role for the PRA as prudential regulator to specify a minimum amount of capital for firms to hold. This does not however diminish the need for firms themselves to judge the adequacy of their capital position in an appropriately prudent manner, since that is necessary to maintain the confidence of their creditors. Firms should engage honestly and prudently in assessments of capital adequacy, not least because the PRA's limited resource means that it cannot be expected to identify and account for all the risks that firms may face.

116. The rest of this section sets out, at a high level, what the PRA expects with respect to the quality and quantity of firms' capital, including the main elements of the regulatory framework that inform the minimum level of regulatory capital that firms are required to maintain. In many cases these expectations are directly reflected in the Capital Requirements Regulation and PRA rules, and more generally elaborate on the 'prudent conduct' Threshold Condition.

117. Reflecting the importance of combining firm-specific supervision with oversight of the financial system as a whole, there is in addition a macroprudential objective in respect of capital maintained in aggregate by the banking system. This objective, and elements of macroprudential assessment more generally, for example top-down stress tests,<sup>(1)</sup> fall under the purview of the FPC.<sup>(2)</sup>

### Quality of capital

118. **The PRA expects a significant part of a firm's capital to be ordinary shares and reserves.** These are the highest-quality form of capital as they allow firms to absorb losses on a going concern basis — that is, without prompting the winding up or legal reorganisation of the firm and consequent disruption and loss of value.

119. **The PRA expects all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure.** To this end, the PRA expects all capital instruments to meet the clearly-stated internationally agreed criteria around the definition of capital,<sup>(3)</sup> and it expects firms to comply with these criteria in spirit as well as to the letter in structuring capital instruments. Reflecting this, the PRA expects firms to refrain from innovation to structure new capital instruments intended to contribute to meeting their regulatory requirements if these are ineffective (or less effective) in absorbing losses. The PRA will not permit firms to count such instruments as capital where their incentive is to minimise issuance cost and promote the attractiveness to investors at the expense of genuine loss-absorbing capacity.

120. While less valuable in terms of the PRA's objective, lower-quality capital (for example, subordinated loan capital) can play a role in absorbing losses if a firm has failed. In these circumstances, such capital in sufficient quantity and appropriate location in the firm can, in combination with an effective and credible resolution regime, assist the authorities to maintain continuity of supply of the critical economic functions provided by a firm and maintain financial stability and confidence in the financial system. Additionally, if it is feasible to ensure such capital is loss absorbing, it may increase creditors' confidence in the firm insofar as it reduces the amount they would lose in the event of failure. And where deposits are insured by the FSCS, this capital can ultimately absorb some of the losses which the scheme would otherwise incur, thus protecting other surviving firms from which the FSCS would recover these losses.

### Location of capital

121. The PRA is mindful that capital resources are not always freely transferable around a group when it matters most. Therefore, **the PRA expects capital to be located in the regulated entities where it is needed.** Creditors' and counterparties' claims are on specific legal entities, not on groups, and should a firm fail, its orderly resolution will be facilitated if individual legal entities, and UK subgroups, hold capital commensurate with their risks. In order to support the integrity of individual regulated entities, the PRA will limit their intra-group exposures.

### Level of capital

122. **The PRA expects firms to take responsibility for maintaining at all times an adequate level of capital, consistent with their safety and soundness and taking into account the risks to which they are exposed.** Capital should be sufficient to absorb unexpected losses, including those arising from uncertainties about provisions and valuations, in a wide range of severe but plausible stresses, both market-wide and firm-specific. Such an approach is designed to maintain the confidence of a firm's creditors even in stressed circumstances.

123. The PRA itself forms judgements about how much capital individual firms need to maintain, given the risks to which they are exposed and uncertainties about the values of assets and liabilities (except in the case of credit unions, which must abide only by the PRA's minimum prudential standards for these firms). The PRA's judgements should inform firms' own assessments. **But the PRA expects firms in the first instance to take responsibility for determining the appropriate level**

(1) For more information, see FPC discussion paper on stress testing available at [www.bankofengland.co.uk/financialstability/fsc/Documents/discussionpaper1013.pdf](http://www.bankofengland.co.uk/financialstability/fsc/Documents/discussionpaper1013.pdf).

(2) See FPC policy statement, published January 2014, available at [www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement140113.pdf](http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement140113.pdf).

(3) For banks, building societies and designated investment firms, those set out in the Capital Requirements Regulation which implement the Basel Committee standards issued in December 2010; for credit unions, those currently set out in the Credit Union Sourcebook.

**of capital they should maintain.** Firms should engage honestly and prudently in the process of assessing capital adequacy, and not rely on regulatory minima when these are inappropriate for the risks to which they are exposed. And they should not rely on aggressive interpretations of accounting standards, especially in calculating asset valuations and loan loss provisions.

**124. The PRA expects all banks, building societies and designated investment firms to develop a framework for stress testing and capital management that captures the full range of risks to which they are exposed and enables these risks to be stressed against a range of plausible yet severe scenarios.** In support of this, the PRA expects all firms to ensure that assets and liabilities are appropriately valued and that provisions are adequate. Firms should also take into account the effect of asset encumbrance insofar as it may reduce loss-absorbing capacity in resolution or liquidation. For its part, the PRA ensures the stresses applied are appropriately prudent.

**125. Banks, building societies and designated investment firms are expected to develop, as a matter of routine, management actions in response to stress scenarios.** Recovery plans — designed to return firms to a stable, sustainable position following firm-specific or market-wide stress — should include options to address capital shortfalls through generating capital internally and externally, and taking into account possible liquidity and profitability pressures. Recovery plans are developed and owned by firms, which should put in place appropriate governance processes and triggers to ensure timely implementation in stress. Plans to generate capital internally should include restricting dividends and variable remuneration. The PRA assesses the adequacy of firms' recovery plans, in terms of the adequacy of the recovery options they identify and the triggers and governance to activate them.

### The framework for determining regulatory capital

**126. For all banks, building societies and designated investment firms, the PRA determines a minimum regulatory capital level and a buffer on top of this expressed in terms of the Basel and EU risk-weighted framework.** It comprises three parts:

- *Pillar 1* — requirements to provide protection against credit, market and operational risk, for which firms follow internationally agreed methods of calculation and calibration.
- *Pillar 2A* — requirements advised by the PRA reflecting:
  - (i) estimates of risks either not addressed or only partially addressed by the international standards for Pillar 1 (for example interest rate risk in the banking book or risks associated with firms' own pension schemes); and

- (ii) PRA estimates of the capital needed to compensate for shortcomings in management and governance, or risk management and controls (including valuation and accounting practices). The latter is designed to guard against unexpected losses while the deficiencies are addressed, and is not a long-term substitute for adequate standards in the underperforming areas.

Pillars 1 and 2A together represent what the PRA regards as the minimum level of regulatory capital a firm should maintain at all times in order to cover adequately the risks to which it is exposed.

- *Pillar 2B* — guidance from the PRA reflecting a forward-looking assessment of the capital required to ensure that firms' minimum level of regulatory capital can be met at all times, even after severe but plausible stresses, when asset valuations may become strained. The PRA's assessment of this 'Capital Planning Buffer' (CPB) takes into account the options a firm has to protect its capital position under stress, for example through internal capital generation.

The CPB is intended to be drawn upon in times of stress. The PRA therefore expects and will allow it to be used in stressed circumstances. If a firm's CPB is used, the PRA will expect the firm to indicate how it plans to rebuild it and over what timescale.

127. The Capital Requirements Directive (CRD IV) included a number of additional buffers which will be phased in from 2016. The PRA has signalled its intention to replace the Pillar 2B buffers with a PRA buffer and it will consult on this before the end of 2014.

### Internal capital models

**128. Although firms may use internal models to help to quantify their Pillar 1 capital requirements, the PRA is generally sceptical that this approach on its own can provide an appropriate basis to calculate capital requirements.** This reflects the misalignment between firms' incentives and the regulator's desired outcomes, and so the potential for firms to use models to game regulatory requirements by masking the inherent riskiness of activities. Models can be complex and time consuming to review, and biases can be well hidden. In addition, and as described in paragraph 107, there are inherent difficulties in measuring risk using models, including limitations from their structure and complexity, the data used as inputs and the underpinning assumptions.

129. The PRA's overarching principle is that it expects firms to maintain at all times an amount of capital that adequately reflects the risks to which they are exposed. In consequence, **if firms use internal models in calculating their regulatory**

**capital requirements, the PRA expects the models to be appropriately conservative.** Where the PRA judges the conservatism applied in internal models not to be sufficient, it will take appropriate action to address the situation, which can include requiring methodological adjustments or recalibration, setting capital floors or imposing adjustments to modelled capital requirements.

130. Importantly, **where internal models are used for regulatory capital purposes, they should contribute to prudent risk management and measurement.** Consistent with this, firms should not select between internal model-based and non model-based 'standardised' approaches to calculating capital adequacy on the basis of lower capital requirements. Where separate models are used for regulatory capital purposes and for internal purposes, the firm must be able to explain the difference between those models and show that they are reasonable.

131. A firm should use a model as the basis for its capital calculation only where model calibration, controls and governance arrangements are adequate, with the model and its output subject to effective, ongoing and independent validation to ensure that it is performing as anticipated. The PRA expects firms not to use internal models for particular asset classes where it judges that it is not possible to measure risk to a sufficient degree of confidence, notably because of a lack of data.

### Leverage and concentrations

132. **To supplement the risk-weighted capital regime, firms should take into account leverage and concentrations of exposures when assessing the adequacy of capital levels.** In particular, the PRA expects firms to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage and indicative minimum leverage ratio, and so whether they maintain sufficient capital on a non risk-weighted basis. In addition, it expects firms to observe prudent limits on large exposures to individual counterparties, to help prevent a serious loss of capital in the event of a single default. More generally, firms are expected to run their businesses without excessive concentrations.

### Supervision — Approval of internal models, Individual Capital Guidance and the Capital Planning Buffer

133. Where they are approved by the PRA, UK firms are able in principle to use internal models to quantify Pillar 1 capital requirements. **When approving internal models, the PRA's focus is on ensuring that the capital requirements arising from them are appropriate when compared with other approaches, historical experience, other firms and earlier estimates of capital requirements for the same firms.** Firms must have their models approved by the PRA before use, and the PRA will consider withdrawing approval if it ceases to be convinced that the model is meaningfully measuring risk. The

PRA may also choose to review a firm's approach to provisioning or its valuations of trading book and other fair-valued assets and liabilities, to identify where it is out of line with peers.

134. For all banks, building societies and designated investment firms the PRA undertakes a regular review of a firm's capital adequacy and its approach to capital management. As part of this, the PRA comes to a judgement on the amount of supplementary capital required under Pillar 2A to cover risks not covered in Pillar 1 and issues the firm with 'Individual Capital Guidance' (ICG) expressing this. The PRA may update ICG at any time. It ordinarily updates its supervisory review of firms' capital adequacy annually, although the nature of the update will vary. For those firms that pose the greatest risk to financial stability, the ICG is typically reviewed in depth every year. For other firms it is normally reviewed in depth in alternate years. The PRA does not issue ICG for credit unions. The PRA intends to continue to require firms to submit their proposed Pillar 2A requirement to inform the review. Further information on the PRA's approach to setting Pillar 2A requirements will be communicated to firms in due course.

135. As part of this review, the PRA also issues firm-specific Capital Planning Buffer guidance — expressed in terms of a quality and quantity of capital to be held towards Pillar 2B — informed by stress tests and a rounded judgement of firms' business models. Annual forward-looking stress testing, tailored to firms' particular risks, plays an important part in the PRA's judgements about a firm's financial soundness in the presence of inevitable uncertainty about future risks. Stress tests cover the quality of lending portfolios, the robustness of asset valuations and provisions, and the liquidity and valuations of trading portfolios. Stress tests are not 'pass/fail' exercises but are instead used to assess the balance of risks arising and to inform ongoing supervisory discussions with firms. As well as expecting firms to conduct their own stress tests, the PRA undertakes detailed tests of its own for the firms with the highest potential impact.

## Liquidity

### Overall approach

136. **Firms have to be able to meet their liabilities on an ongoing basis with sufficient confidence, including in stressed circumstances, consistent with their safety and soundness.**

137. As with all elements of its approach, **the PRA expects firms in the first instance to take responsibility for ensuring they are able to meet their liabilities with sufficient confidence.** Reflecting however the incentives firms have to run their business in a less prudent manner than the public interest would indicate, there is a clear role for the PRA as

prudential regulator in ensuring that firms have an appropriate degree of resilience to liquidity stresses.

138. The PRA specifies to firms what it regards as an appropriate amount of liquidity. This does not, however, diminish the need for firms themselves to determine holdings of sufficient liquidity, since that is necessary to maintain the confidence of creditors and counterparties. Firms should engage honestly and prudently in the process of assessing liquidity risk, not least because the PRA's limited resource and proportionate approach means that it cannot be expected to identify and account for all the risks that firms may face.

139. The rest of this section sets out what, at a high level, the PRA expects of firms when assessing whether they hold adequate liquidity. In many cases these expectations are directly reflected in PRA rules, and more generally they elaborate on the 'prudent conduct' Threshold Condition.

140. Reflecting the importance of combining firm-specific supervision with oversight of the financial system as a whole, there are in addition macroprudential considerations in respect of liquidity held by the banking system as a whole, which fall under the purview of the FPC.

### Liquid assets and maturity mismatch

141. The PRA expects firms to hold an appropriate stock of liquid assets given the degree of maturity mismatch on their balance sheets and the potential for a wide range of severe but plausible short-term stresses.

142. **The PRA expects firms to observe a prudent maturity-mismatch profile**, taking into account the expected behavioural as well as contractual maturities of liabilities. The PRA expects firms not to be reliant on funding from a narrow set of sources, or to rely excessively on short-term wholesale funding sources that may prove difficult to secure during times of stress, taking into account that even access to secured funding can dry up if counterparties have concerns over a firm's solvency. Firms should also avoid reliance on maintaining particular credit ratings in securing and maintaining funding. In considering behavioural maturity, the PRA expects firms to take account of the risk that asset encumbrance poses to unsecured funding and therefore the risk that unsecured funding is withdrawn rapidly in the event of stress.

143. **The PRA expects firms to hold a buffer of high-quality, unencumbered assets that can reliably be traded or exchanged in private markets, including in stressed circumstances.** This buffer should enable a firm to withstand a wide range of severe but plausible stresses, both market-wide and firm-specific. This gives a firm's counterparties confidence that it will be able to repay depositors and creditors on demand and gives a firm a period

of time to take action to deal with liquidity concerns without undue reliance on the Bank of England and other central banks.

144. As with capital, the PRA reaches its own view on the appropriate size and composition of the liquidity buffer that firms should hold in normal, unstressed conditions (see Individual Liquidity Guidance below) except in the case of credit unions, which must simply abide by the PRA's minimum prudential standards for these firms. But the PRA expects firms in the first instance to take responsibility for determining the appropriate size of that buffer, taking into consideration the risks they face. Firms should engage honestly and prudently in the process of assessing liquidity risk, and not rely on regulatory minima.

145. **To support their judgements on the appropriate size and composition of liquidity buffers, the PRA expects firms to develop a framework for managing liquidity risk that captures the full range of liquidity risks to which they are exposed and to stress test these risks and proposed management actions against a range of severe but plausible scenarios.** For its part, the PRA ensures that the stresses applied are appropriately prudent. Beyond monetising the buffer of liquid assets, firms' Contingency Funding Plans (part of recovery plans more generally) should include a wide range of credible management actions to raise liquidity in times of stress. And firms should regularly 'turn over' their liquid assets in size in the market to reduce the risk that they encounter problems in trying to monetise them in times of stress.

146. The PRA is mindful that liquidity resources are not always freely transferable around a group when it matters most. The PRA expects firms to take account of this in **ensuring that liquidity is available without impediment to the regulated entities where it is needed**, including in stressed times.

147. A firm's liquid asset buffer is intended to be used. In stressed circumstances, the PRA therefore expects and allows deviation from the guidance that it issues. And it expects firms to have credible options in their recovery plans for restoring their liquid asset buffers following firm-specific or market-wide stress. During periods of market stress, the PRA allows firms that experience a reduction in their liquid assets as a result of the stress an appropriate period of time to rebuild their buffers fully.

148. Firms are encouraged to take account of the range of liquidity insurance facilities offered by the Bank. These include the regular monthly market-wide Indexed Long-Term Repo (ILTR) auctions aimed at firms with a predictable need for sterling liquidity, the bilateral on-demand Discount Window Facility (DWF) designed for addressing firm-specific or market-wide liquidity shocks and, if activated by the Bank, the Contingent Term Repo Facility (CTRF).

149. All banks and building societies that meet Threshold Conditions may sign up for the Sterling Monetary Framework<sup>(1)</sup> (SMF) and have full access to borrow in its facilities. Banks and building societies which are not currently members of the SMF are encouraged to discuss whether an application would be appropriate. Firms with access should familiarise themselves with the liquidity insurance facilities available; factor the availability of these facilities into liquidity planning; ensure that sufficient collateral is pre-positioned at the Bank to be able to use the facilities and ensure that operational capacity is maintained by conducting periodic test trades with the Bank.

150. There is now international agreement on a minimum standard for liquid asset buffers (the Liquidity Coverage Ratio or the LCR). Provision is made in the Capital Requirements Regulation to introduce this in the European Union. In August 2013, the PRA announced a change to the level of liquidity requirements it would set for firms. This change was made having regard to the forthcoming transition to the LCR. In due course the PRA will set out further details about its transitional approach. It will consider, among other things, the European Commission's delegated act specifying the definition, calibration, calculation and phase-in of the LCR.

### Supervision — Individual Liquidity Guidance

151. The PRA issues banks, building societies and designated investment firms with Individual Liquidity Guidance (ILG) where appropriate regarding the quality and quantity of liquid assets that should make up their buffer in normal times. The PRA may also indicate what it considers to be an appropriate funding profile for the firm, in terms of the composition by different sources and maturities. As noted, the PRA understands and expects that firms may use their liquidity buffers during times of stress.

152. ILG is based on the PRA's analysis of the adequacy of a firm's liquidity position and liquidity risk management practices. The PRA assesses the adequacy of firms' liquidity on an ongoing basis as part of supervision, and may update ILG at any time. For those firms that pose the greatest risk to financial stability, liquidity risk is typically assessed in depth every year. For other firms it is normally assessed in depth in alternate years.

153. For some simpler banks and building societies, the liquid asset buffer may be calculated on the basis of a specified formula in the *PRA Handbook*. Additionally, the PRA does not issue ILG for credit unions.

## Resolvability

### Overall approach

154. One of the key channels through which firms can adversely affect financial stability is through disorderly failure

which disrupts access to critical economic functions. To mitigate this risk, **the PRA aims for a position where the failure of any firm is orderly; that is, where the appropriate degree of continuity of access to a firm's critical economic functions is maintained in resolution such that disruption is contained, avoiding a risk to financial stability or a loss of confidence in the financial system.**

155. In moving towards such a position, the PRA requires action from firms, including restructuring, to improve feasibility of orderly resolution. The Bank's Resolution Directorate (RD) is responsible for exercising the special resolution powers. As a result, the RD supports the work of supervisors in assessing the feasibility of implementing a resolution plan, identification of barriers to firm resolvability and measures for removing those barriers. This work takes full account of any strengthening of UK and international frameworks for resolution so that they meet the standards agreed in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.<sup>(2)</sup> The PRA will support and actively influence domestic and international initiatives to improve UK and overseas firm resolvability.

156. Resolvability is about maintaining the appropriate degree of continuity of access to critical economic functions, and not about preserving firms. A firm's resolvability thus reflects the likelihood that it can fail in an orderly manner. Ensuring firms are resolvable is a PRA supervisory priority, involving the development of a feasible and credible resolution plan with the support of the RD as the resolution authority.

157. This section outlines the PRA's expectations of banks and building societies in respect of resolvability. And although, at this time, there is no special resolution regime for the designated investment firms that the PRA regulates, the Financial Services Act 2012 makes provision for HM Treasury to extend the special resolution regime to cover them. The expectations in this section thus apply equally to designated investment firms. The European Commission's proposed Recovery and Resolution Directive will require member states to introduce a resolution regime for systemically important firms, including investment firms, consistent with the FSB's *Key Attributes*.

158. The PRA applies its resolvability requirements to firms incorporated in the United Kingdom, including subsidiaries of overseas firms. It is also critically important for overseas firms that operate as branches in the United Kingdom to have robust recovery and resolution plans in place. For all firms with substantial operations outside the United Kingdom, the PRA attaches great importance to regular co-operation with the relevant overseas authorities. For global systemically

(1) For more information see [www.bankofengland.co.uk/markets/Pages/money/default.aspx](http://www.bankofengland.co.uk/markets/Pages/money/default.aspx).

(2) See [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

important financial institutions (G-SIFIs) in particular, any resolution would need to be co-ordinated internationally by resolution authorities. The progress of international work by the FSB and other continues to be highly influential in directing the PRA's work in this area.

159. This section does not apply to credit unions, for which no special insolvency or resolution regime currently applies. Credit unions are expected to meet the requirements for a 'single customer view' (as described below), and very few have uninsured creditors. The urgency for a special insolvency or resolution regime for them is therefore low at present.

160. This section elaborates on these broad expectations and more generally on the 'prudent conduct' Threshold Condition and Fundamental Rule 8.

### Expectations of firms

161. The PRA expects firms to co-operate fully with the PRA and the RD in their work to assess and enhance firm resolvability. In particular, **the PRA expects firms to be able to provide the information needed to perform an assessment of their resolvability. To this end, in December 2013, the PRA published final Recovery and Resolution Plan<sup>(1)</sup> rule and the Supervisory Statement 19/13 — Resolution Planning.<sup>(2)</sup> The latter sets out the PRA's information requirements necessary to inform the authorities' selection of the preferred resolution strategy, identification of barriers to its implementation and proposed means of improving resolvability.**

162. The PRA also expects firms to provide any additional information required by the authorities to prepare for their resolution. In particular, **the PRA requires deposit-takers to be able to produce a single, consistent view of each depositor's funds, to enable the FSCS to implement rapid payout (within a target of seven days for the majority of customers).** This 'single customer view' (SCV) is essential to ensure that the FSCS is able rapidly to recompense insured depositors, minimising the adverse effect of firm failure on the stability of the financial system. For small firms whose failure is unlikely to impact financial stability, rapid payout of depositors followed by winding up is the likely resolution plan.

163. **Where significant barriers or obstacles to resolvability are identified, firms are expected to propose and implement adequate changes to remove them.** This may involve changes to business practices or legal and financial structures, and in the future, will reflect reforms in UK and EU law as well as the FSB's international standards in respect of ring-fencing, depositor preference, bail-in powers and loss-absorbency requirements. These reforms are intended to improve the feasibility and credibility of the authorities' resolution strategies. The PRA will expect firms to implement changes to remove barriers to resolvability, in the spirit as well as to the letter of the requirements.

164. Even with an effective resolution regime for all firms, failure is not costless. As described in paragraph 125, **firms must draw up a recovery plan, outlining credible steps that they could take in the event of a stress, to maintain their business and restore it to a stable and sustainable condition.**

### Supervision — Resolution plans

165. The term 'resolvability' has been defined by the FSB as the ability to resolve a firm in a manner that: (1) mitigates adequately the systemic consequences of failure; (2) preserves continuity of access to critical economic functions; and (3) imposes the costs of resolution on shareholders and unsecured creditors of a failed firm, rather than the taxpayer. The PRA, with the support of the RD, assesses the extent to which each firm is resolvable. Based on this assessment, the RD, with the support of the PRA, sets a preferred resolution strategy for a firm. The authorities own this plan, updating it as necessary (for example following changes to firm structures or legal framework).

166. In their assessment, the authorities are mindful of the different types of resolution strategy that can be implemented, and the advantages and disadvantages of each. The PRA is responsible for ensuring firms can be feasibly and credibly resolved under the preferred resolution strategy. If a firm is not resolvable without risk to the authorities' objectives, it will be directed by the authorities to take action.

167. The UK authorities co-ordinate with authorities in other relevant jurisdictions to develop co-ordinated strategies and plans for the resolution of G-SIFIs, and other cross-border firms, in line with the FSB *Key Attributes*. They enter into firm-specific co-operation agreements, which (among other things) set out the process for information sharing before and during resolution, and provide an appropriate level of detail with regard to the cross-border implementation of resolution strategies and plans.

168. In all areas, the PRA co-operates closely with the RD, given the RD's responsibility for use of resolution powers if the PRA judged a firm to no longer meet its threshold conditions and this was not reasonably likely to be rectified. In assessing resolvability, the PRA also consults HM Treasury, the FCA, the FSCS and other authorities where appropriate.

(1) For the policy statement, see [www.bankofengland.co.uk/pradocuments/publications/policy/2013/recoveryresolution8-13.pdf](http://www.bankofengland.co.uk/pradocuments/publications/policy/2013/recoveryresolution8-13.pdf).

(2) For the supervisory statement, see [www.bankofengland.co.uk/pradocuments/publications/policy/2013/resolutionplanning1913.pdf](http://www.bankofengland.co.uk/pradocuments/publications/policy/2013/resolutionplanning1913.pdf).

## IV Supervisory activity

169. This section describes how in practice the PRA supervises firms. As part of this, it describes the PRA's approach to authorising new firms (see Box 5), the Proactive Intervention Framework and the PRA's high-level approach to using its legal powers. For UK firms, the PRA's assessment covers all entities within the consolidated group.

170. The PRA's supervision involves engagement with firms at all levels of seniority. At a senior level, boards as a whole, and the independent directors in the absence of executive management, should expect regular dialogue with the PRA, either in groups or on an individual basis. The PRA always focuses on material issues in its engagement with firms.

### Assessing risk

171. The PRA aims to develop a rounded, robust and comprehensive view of a firm, in order to judge whether it is being run in a safe and sound manner. **The PRA conducts its assessment work on a continuous cycle**, regularly updating its overall view of a firm, the risks it faces and the risks it poses.

172. The PRA undertakes a set of core supervisory activities to inform its overall assessment of a firm. Reflecting the PRA's focus on the biggest risks to its objectives, the exact work making up this core increases in frequency and intensity in line with a firm's potential impact (ie its Category). It also varies with other factors including UK legal status (see Box 6). Those firms that are unlikely individually to create disruption to the wider financial system (see Box 8) are subject to a baseline level of supervisory activity to ensure that they meet key prudential standards, whereas for higher-impact firms the PRA makes use of a fuller selection of its supervisory tools. Although the PRA's approach to the supervision of mutuals is consistent with the approach adopted for other firms, it also recognises that there are issues that are specific to the mutual sector, for example the statutory restrictions on business and limitations in their ability to raise external capital.

173. Additional work is performed where necessary to provide information on particular areas of concern, taking into account a firm's resilience and resolvability, the prevailing market and economic conditions, and the business model of the firm.

174. Supervisory concerns influence the PRA's future supervisory approach to a firm. For example, concerns about management or systems and controls influence the PRA's attitude to the growth of a business, including via acquisition, or to new appointments to Significant Influence Functions.

175. **The PRA is not formulaic about the supervisory activity it performs, since the focus on key risks means that this will**

**depend on a firm's particular circumstances.** Nonetheless, its supervisory work comprises a selection of the possible activities described below.

### Supervisory activities and tools

176. In forming supervisory judgements, the PRA draws on a broad set of information and data. **Supervisors require firms to submit sufficient data, of appropriate quality, to inform their judgements about key risks.** Given the importance of this, the PRA periodically validates firms' data, either through on-site inspection by its own supervisory and specialist risk staff or by third parties.

177. The PRA gathers and analyses some information on a regular basis, for example through regulatory returns. It also analyses relevant information in the public domain, for example firms' annual reports and disclosures. Also, it may request additional, firm-specific data from firms (for example management information or forecasts). It is essential, however, that supervisors are not overwhelmed by the amount of information that they have to analyse.

178. To support its information-gathering and analysis, the PRA requires firms to participate in meetings with supervisors at a senior and working level. Some discussions are strategic in nature, while other interactions focus on information-gathering and analytical work.

179. The PRA also, as appropriate, conducts detailed on-site testing or inspections of a particular area. In-depth, focused reviews, for example of a firm's proprietary trading desk or its approach to valuations or risk weightings, involve discussions with staff, reviews of internal documents and some testing. In addition, the PRA may review a firm's approach to stress testing, or undertake bespoke stress testing of its own. The PRA involves its risk specialists and other technical staff in on-site work, stress testing and other assessments as appropriate. And the PRA may use firms' risk, compliance and internal audit functions to identify and measure risks, where it feels it can rely on their effectiveness.

180. **Firms' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in a firm.** As required by the Act, the PRA maintains arrangements to provide a firm's external auditors with relevant data and information, for example, if it considers a firm's valuations of less liquid assets or its approach to provisioning to be significantly out of line with its peers, as well as exchanging opinions with those auditors on the implications of such information. The PRA expects to work with firms' external auditors in an open, co-operative and constructive manner, and will maintain rules setting out the duties external auditors will have to co-operate with the PRA in connection with its supervision of PRA-licensed firms. It expects auditors to



## Box 5

### Authorising new firms

Firms wishing to undertake deposit-taking activities must apply to the PRA for authorisation to do so. The PRA assesses applicant firms from a prudential perspective, using the same framework that is employed for supervision of existing firms. Thus, the PRA determines whether, if authorised, an applicant firm would meet the Threshold Conditions, at the point of authorisation and on an ongoing basis. This includes an assessment of whether it could be resolved in an orderly way.

At the same time, the FCA assesses applicants from a conduct perspective. An applicant is granted authorisation only where both the FCA and the PRA are satisfied that it meets the relevant requirements. As provided for in the MoU, the PRA leads and manages a single administrative process. This includes co-ordinating the process and transmitting all formal notices and decisions to the applicant firm.

The PRA sets out the information that it requires firms to supply in order to complete its assessment. It stands ready to answer questions where necessary, though this does not extend to providing consultancy on completing applications. The PRA, along with the FCA, has committed to engaging with applicants at an early stage via pre-application meetings, which will aim to produce as complete an application as possible.

disclose to the PRA emerging concerns within firms, where this would assist the PRA in carrying out its functions. The PRA has published a *Code of Practice*<sup>(1)</sup> detailing the arrangements it will maintain with firms' external auditors in order to promote a mutually beneficial and constructive relationship. The Act requires the PRA to meet at least once a year with the auditors of each deposit-taker and investment firm that is, in the opinion of the PRA, important to the stability of the UK financial system.

181. To assist with its risk assessment, the PRA may at times use its statutory powers — in particular its information-gathering power and its powers to commission reports by Skilled Persons on specific areas of interest (under sections 165 and 166 of the Act respectively). Such reports might cover verifications of regulatory returns or, with the RD where appropriate, the forensic analysis required to verify resolution plans. The PRA may enter into contracts with Skilled Persons directly, following a transparent and consistent approach to selecting and appointing them.

182. The PRA also makes use of the FCA's findings on firms' key conduct risks (including money laundering) and any material prudential risks in relation to FCA-authorised

The PRA takes a proportionate approach to the assessment of applications. All applicants are subject to a minimum level of assessment, beyond which work is commensurate with the potential impact of a firm's failure on the financial system.

The PRA ensures that, at the point of authorisation and consistent with EU requirements, new banks hold capital sufficient to cover the risks that they run. The PRA also aims for barriers to entry to be kept to the minimum consistent with its safety and soundness objective, thereby facilitating an effective competitive banking market. The publication by the Bank and the FSA on barriers to entry sets out how the PRA will achieve this, through reduced liquidity requirements for all new entrants, and reduced capital requirements in the first three to five years following authorisation for resolvable new entrants with no systemic impact. Those new entrants authorised with reduced capital requirements should have a credible plan to build up their capital buffers over an agreed period to levels comparable with similar but established authorised firms. This plan will include constraints on dividend distribution and variable remuneration where appropriate, for example where certain minimum EU buffer requirements are not met.<sup>(1)</sup>

(1) See [www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf](http://www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf).

subsidiaries of dual-regulated groups, where they are materially relevant to the PRA's objective.

183. The PRA is not a 'fraud' regulator; this role is filled by other authorities. The PRA's on-site inspections are not therefore designed to uncover all instances of malpractice. Rather, the PRA aims to assess the adequacy of a firm's control framework in preventing serious fraud that could threaten its safety and soundness, drawing to the attention of the relevant authorities any suspicion or information that may be of material interest to them.

### Proactive Intervention Framework

184. Supervisors consider a firm's proximity to failure when drawing up its supervisory plan. **The PRA's judgement about proximity to failure is captured in a firm's position within the Proactive Intervention Framework (PIF).**

185. Judgements about a firm's proximity to failure are derived from those elements of the supervisory assessment framework

(1) For more information on the *Code of Practice*, see [www.bankofengland.co.uk/publications/Documents/other/pr/policy/2013/codeofpracticelss7-13.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pr/policy/2013/codeofpracticelss7-13.pdf).

**Table A** Stages in the Proactive Intervention Framework

Stage	Possible supervisory actions
Stage 1 – Low risk to viability of firm	<ul style="list-style-type: none"> <li>— Firm subject to the normal supervisory risk assessment process and actions, including recovery and resolution planning.</li> </ul>
Stage 2 – Moderate risk to viability of firm  Supervisors have identified vulnerabilities in a firm's financial position or deficiencies in its risk management and/or governance practices.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— The intensity of supervision will increase. The PRA may set additional reporting requirements, and/or make use of information-gathering powers.</li> <li>— The PRA will require the firm to act to address deficiencies identified over a set period.</li> <li>— The firm will be required to update its recovery plan and may need to activate it.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA, with the support of the RD, will assess the firm's resolvability against the authorities' preferred resolution strategy and identify changes necessary to ensure the resolution plan can be feasibly implemented in the event of firm failure.</li> <li>— The FSCS will evaluate the quality of data provided to support a single customer view and any obstacles to payout or deposit transfer.</li> </ul>
Stage 3 – Risk to viability absent action by the firm  Significant threats to a firm's safety and soundness have been identified.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— The PRA may require any of the following actions: a change to management and/or composition of the board; limits on capital distribution (including dividends and variable remuneration); restrictions on existing or planned business activities; a limit on balance sheet growth and/or stricter leverage limits; and setting tighter liquidity guidelines and/or capital requirements.</li> <li>— The firm will be required to draw on the menu of options set out in its recovery plan as appropriate.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA and RD will intensify engagement on contingency planning for resolution and will have all means necessary to obtain the information it considers it needs to carry out that task.</li> </ul>
Stage 4 – Imminent risk to viability of firm  The position of a firm has deteriorated such that the PRA assesses that there is a real risk that the firm will fail to meet the Threshold Conditions, but some possibility of corrective action remains.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— The PRA will most likely increase the scale of the recovery actions needed (including in relation to liquidity and capital). The PRA will set out a timetable for implementation of recovery actions.</li> <li>— Firm-led recovery actions will need to be effected in short-order and the firm will need to demonstrate that these were credible and will produce material results.</li> <li>— Actions initiated following activation of the recovery plan, including on asset disposal (or sale of firm), will need to be completed.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The RD and FSCS, where relevant, will confirm that all necessary actions to prepare for the resolution of the firm had been taken, including that relevant data were readily available.</li> </ul>
Stage 5 – Firm in resolution or being actively wound up	<p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA will determine the firm no longer meets threshold conditions and this is not reasonably likely to be rectified.</li> <li>— Where appropriate the RD will take the firm into the Special Resolution Regime overseeing the resolution or winding up of the firm.</li> <li>— The FSCS may be required to effect depositor payout and/or to fund deposit transfer or resolution.</li> </ul>

that reflect the risks faced by a firm and its ability to manage them — namely, external context, business risk, management and governance, risk management and controls, capital and liquidity. The PIF is not sensitive to a firm's potential impact or resolvability.

186. The PIF is designed to ensure that the PRA puts into effect its aim to identify and respond to emerging risks at an early stage. There are five clearly demarcated PIF stages, each denoting a different proximity to failure, and every firm sits in a particular stage at each point in time (Table A). When a firm moves to a higher PIF stage — ie as the PRA determines that

the firm's viability has deteriorated — supervisors will review their supervisory actions accordingly. Senior management of firms will be expected to ensure that they take appropriate remedial action to reduce the likelihood of failure. And the authorities will ensure appropriate preparedness for resolution.

187. A firm's PIF stage is reviewed at least annually, and in response to relevant, material developments.

188. The PRA considers it important for markets and counterparties to make their own judgements on the viability of a firm. The PRA will not therefore routinely disclose to the

market its own judgement on a firm's proximity to failure, not least given the possible risk that such disclosures could act to destabilise in times of stress. The PRA would prefer to disclose PIF stages to regulated firms as a means of summarising the PRA's overall judgement on safety and soundness. In view of the current disclosure obligations in European legislation, however, the PRA has decided not to do so, given the risk that in some cases the firm may be under a legal obligation to disclose its PIF stage publicly. The PRA is engaging with HM Treasury to discuss whether it would be appropriate to pursue changes to relevant European legislation to support disclosure of such supervisory judgements to firms but not to the market generally.

189. The PRA will publish aggregate statistics on the number of firms in each PIF stage on the Bank of England website.<sup>(1)</sup>

## Mitigating risk

190. The PRA continually reviews its judgement of the risks to firms' safety and soundness, on the basis of the supervisory activities undertaken. It communicates these judgements to firms, and requires them to take action as a result.

191. As a matter of routine, there are annual, internal stock-take meetings for all firms to discuss the major risks they face, the supervisory strategy and proposed remedial actions, including guidance about the adequacy of a firm's capital and liquidity (as described in Section III). There is strong senior level involvement in these assessments, such that major judgements are made by the PRA's most senior and experienced individuals. These formal assessments are also subject to rigorous review by those not directly involved in day-to-day supervision — including risk specialists, independent advisers and relevant participants from the rest of the Bank, such as the RD.

192. **There is a clear and direct link between the risks that the PRA perceives and the actions it expects from firms in consequence.** For example, if the PRA has identified deficiencies in a firm's forecasts of earnings, or an excessive level of proposed employee remuneration or dividends to shareholders, leading to risks to its financial health, the PRA will require the firm to take steps to tackle this. This may involve direct restrictions on payments, or requirements on the firm to improve its forecasting, systems or governance as appropriate. Or the assessment may have revealed that senior management has an inadequate view of the firm's liquidity risk, compromising the effectiveness of the firm's governance and, in consequence, the firm's soundness. The PRA may then expect the firm to enhance internal systems for monitoring liquidity risk, or to review the design and effectiveness of its governance and reporting lines.

## Conveying supervisory messages

193. The PRA focuses on outcomes. **The PRA highlights issues of concern and the outcomes it wishes to see but, as it is the responsibility of a firm to manage itself, in general the way in which firms achieve these outcomes is a matter for them.** In some cases the PRA may choose to be directive in terms of the action required, if it considers it necessary in order to reduce risks to its objective.

194. The PRA sends an annual letter to each firm's board, clearly outlining the small number of key risks that are of greatest concern, and on which it requires action. **The test of materiality for points raised with firms is high, with a focus on root cause analysis rather than symptoms, and with supervisory interventions clearly and directly linked to reducing risks to financial stability.** The PRA expects to verify itself that action is taken on these key risks, and communicates to the board when and how it intends to do this. The PRA sends individually tailored letters to all firms, except those with the lowest potential impact where a standard letter outlines issues relevant to all firms in that group, unless specific issues have been identified with a particular firm. The PRA actively engages with a firm's Audit Committee and its non-executive directors on progress made in addressing the most significant risks identified.

195. Firms may sometimes disagree with the PRA's decisions. This is inherent in a forward-looking system. The PRA in general discusses issues with firms in reaching its decisions, and carefully considers representations made, not least to ensure that its decisions are made on the basis of all the relevant evidence. **But firms should not approach their relationship with the PRA as a negotiation.**

196. Any less significant issues that have arisen — and of which the PRA feels the firm should be aware — are conveyed to the firm, but with the onus on the firm itself to address these. The PRA expects self-certification by the most appropriate senior individual within the firm, for example the CEO, Finance Director or chair of the Audit Committee, that issues have been closed. The link between the issues raised and the PRA's objective remains clear and direct.

## Using powers in the course of supervision

197. The PRA has a variety of formal powers available to it under the Act, which it can use in the course of its supervision, if deemed necessary to reduce risks. These include powers by which the PRA can intervene directly in a firm's business. For example, it may vary a firm's permission or impose a requirement under Part 4A of the Act to prevent or curtail a firm undertaking certain regulated activities, which may

(1) For more information, see [www.bankofengland.co.uk/pradocuments/supervision/pifscores.pdf](http://www.bankofengland.co.uk/pradocuments/supervision/pifscores.pdf).

## Box 6

### International approach

Banking is an international industry. Supervision of overseas firms operating in the United Kingdom, and consolidated supervision of international groups operating in the United Kingdom via supervisory colleges, are therefore important parts of the PRA's work.

The PRA's legal powers and responsibilities vary depending on the location of the parent and the legal form of its operations in the United Kingdom. Regardless of this, the PRA's supervisory approach is to assess all firms to the same prudential standards. Where the PRA does not have direct powers against such firms, it will raise any concerns that it has with the firm's home state supervisor or at the appropriate international forum.

#### Supervision of overseas firms operating in the United Kingdom

Many overseas firms operate in the United Kingdom and are significant providers of financial services to the UK economy. As with UK firms, the PRA's supervision of overseas firms operating in the United Kingdom reflects an assessment of the potential impact of the UK entity on UK financial stability, including via risks from overseas, its legal status (branch or subsidiary), the nature of the home country regulatory regime (where the firm originates from a non-EEA country) and whether or not the firm is a G-SIFI.

**For subsidiaries of overseas firms** the PRA has full powers and responsibilities and so its approach is to treat such firms equivalently to UK-owned firms (applying its full prudential requirements, including for example stress testing for the most significant firms). Consistent with its objective the PRA assesses, and limits as necessary, the (potentially complex) interlinkages with the rest of the group.

**For UK branches of EEA firms**, the PRA's powers and responsibilities are limited under European law. In order to assure itself that risks to the UK financial system from such branches are adequately managed, the PRA focuses on resolution planning (along with the RD) and on ensuring that it has access to relevant information on the safety and soundness of the parent firm via collaboration with home regulators. In particular the PRA engages in supervisory and resolution colleges, including Crisis Management Groups (CMGs) where applicable. The PRA takes a close interest in liquidity, focusing, in collaboration with the home regulator, on the position of the whole firm of which the branch is a part.

The PRA expects UK branches of EEA firms to appoint a senior individual with authority to act as a primary contact with the

PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent.

Where the PRA is not satisfied regarding the safety and soundness of the branch and the parent firm, it works with the home authority and promotes public understanding of the limits of its powers, and uses whatever tools it can to reduce the impact of these limitations. In emergency situations, consistent with European law, the PRA will take any precautionary measures necessary to protect the interests of depositors, and will inform the home authority of such measures at the earliest opportunity.

In some cases, the PRA may judge that an EEA firm applying to passport into the United Kingdom poses risks to its objective, but does meet the requirements set out by the relevant EU Directives, and thus as a legal matter has a right to conduct business in the United Kingdom. In such cases, the PRA will carefully consider the tools available to it as a host regulator, acting in co-operation with the home regulator, to mitigate the resulting risks.

**For UK branches of non-EEA firms**, the PRA's authorisation applies to the whole firm. At the point at which a non-EEA branch seeks initial authorisation in the United Kingdom, the PRA will, as a first step, form a judgement on the adequacy of the home regulator, including its ability and willingness to share confidential information. Where it considers the home supervisor not to have a regime broadly equivalent to that of the United Kingdom, the PRA will refuse authorisation of the branch. It may instead decide to authorise a stand-alone subsidiary, in which case it may limit the interlinkages with the rest of the group or ring-fence the subsidiary (for example if it considers the home supervisor not to deliver effective consolidated supervision). In assessing a non-EEA firm against the Threshold Conditions, the PRA may also have regard to the opinion of an overseas regulator in a country in which the firm carries on regulated activities. In considering how much weight to attach to such opinions, the PRA must have regard to the nature and scope of the supervision exercised by the overseas regulator.

For existing UK branches of non-EEA firms where the home regime is not considered to be equivalent, the PRA's supervisory work is aimed at mitigating the risks of non-equivalence in the relevant areas. Its supervision focuses on issues such as the financial strength of the whole firm, including the adequacy of its liquidity and the resolution plan for the firm (collaborating with the RD and home authorities to develop such plans in colleges or CMGs as applicable), taking into account the importance of the firm to the PRA's objective.

For UK branches of non-EEA firms where the PRA is satisfied that the home regulatory regime is equivalent, and where the

PRA has assured itself over resolution plans and the home regulator's supervisory approach, the PRA relies where possible on the home regulator's prudential supervision. In these cases, the PRA focuses on collaboration with home regulators (including via supervisory colleges) and on resolution plans. In addition, the PRA takes a close interest in liquidity and ensures that there are senior individuals in the United Kingdom that are clearly responsible for management of both the UK operations and business booked in the United Kingdom. The PRA discusses and agrees with the home regulator the areas in which it will seek to rely on the home regulator's supervision.

### Supervisory colleges

The PRA is an active participant in international co-ordination of supervision for major firms. Where invited to do so, it participates in supervisory colleges for all firms with significant operations in the United Kingdom, whether a legal entity or a branch.

For UK firms, the PRA organises and chairs the supervisory college. To be fully effective, colleges must operate in a

manner that enables supervisors to be open and transparent with each other, and to address the difficult issues. The PRA seeks to adopt this approach when it runs colleges and expects other authorities to participate on the same basis. As the lead authority and college chair for major UK firms, the PRA is prepared to tackle instances where it believes that other authorities are not acting in a manner consistent with the PRA's objectives. And the PRA encourages other authorities to challenge it if they have concerns. EU processes are increasingly well-developed: it is already a requirement for all prudential European supervisors of pan-European groups to work together to reach a joint risk assessment and decision on capital adequacy, and this is likely to extend to joint decisions on whether firms hold adequate liquidity in the future. The PRA works closely with other European supervisors to reach these joint decisions.

A consultation paper on the PRA's approach to the supervision of overseas firms operating in the United Kingdom was published on 26 February 2014 and firms have been invited to respond by 27 May 2014.

require a change to a firm's business model or future strategy. It may also, as noted above, use its powers to require information from firms.

198. **While the PRA looks to firms to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes.** This means that, in certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort. This can include addressing serious failings in the culture of firms, as detailed in Box 7.

199. The PRA considers when and how to use its formal powers on a case-by-case basis and assesses the particular facts and circumstances of each case. In all cases, the PRA is likely to consider a number of factors in connection with the possible deployment of such powers, including:

- the confidence supervisors have that firms will respond appropriately to the PRA's requests without the use of powers;
- the PRA's view of the firm's proximity to failure, as reflected in its PIF stage; and
- the likely impact — including systemic implications — of the firm's failure.

200. In addition, the PRA may use its powers to approve or allow certain changes requested by firms (for example, a change in a firm's controller or in its permissions to perform regulated activities). Where those changes could adversely

affect the safety and soundness of the firm, the PRA may use its powers to refuse such requests.

### Enforcement powers

201. The PRA's preference is to use its powers to secure *ex ante*, remedial action by firms, given its approach of intervening early to address emerging risks.

202. **The PRA does, however, have a set of disciplinary powers, including the power to impose financial penalties or publish public censures, for cases where such a sanction is an appropriate response to the firm failing to meet the PRA's regulatory requirements.**

203. The PRA deploys disciplinary powers to advance its objectives in line with its priorities. Use of enforcement powers can achieve this by changing, and promoting high standards of, behaviour among firms; sending a clear signal to a firm, and to the regulated community more widely, about the circumstances in which the PRA considers a firm's behaviour to be unacceptable; and deterring future misconduct.<sup>(1)</sup> In this way, *ex-post* enforcement against one firm can help serve a wider preventative purpose.

204. The PRA has the power to institute criminal proceedings in respect of a small number of criminal offences. When it decides whether or not to bring criminal proceedings in

(1) For more information on the PRA's policy on its use of its powers, see [www.bankofengland.co.uk/pr/Pages/publications/approachenforcement.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/approachenforcement.aspx).

## Box 7

### Use of powers to address serious failings in the culture of firms

The PRA expects firms to have a culture that supports their prudent management, and the PRA seeks to address serious failings in culture as part of its approach to supervision. If serious failings in culture are identified, the PRA has a variety of powers which it may use if deemed necessary to reduce risks and achieve desired supervisory outcomes. The PRA acts pre-emptively to tackle concerns it identifies and to prevent a firm posing risks to its objectives.

The PRA has the power to impose a requirement under Part 4, section 55M of the Act on a firm to undertake or cease a particular action. One of the grounds for exercising this power is if it appears to the PRA that it is desirable to exercise the power in order to advance any of the PRA's objectives. It therefore enables the PRA to take early intervention action should failings in the culture of a firm pose a risk to the PRA's objectives.

There is substantial flexibility for the PRA to tailor requirements specific to the circumstances of a firm and the

nature of the PRA's concerns, including serious cultural failings. Requirements may include (but are not limited to), requiring the firm to address concerns identified by the PRA, requiring the nomination of an individual within a firm to have responsibility for recommendations specified by the PRA, or requiring the retention of an independent individual to ensure compliance with PRA recommendations, as judged necessary by the PRA (the latter can also be achieved under section 166 of the Act).

The PRA does not have to publicise the imposition of requirements if publication would be unfair to the person concerned, or prejudicial to the safety and soundness of a firm.

It may also be appropriate to use the PRA's own-initiative variation of permission power under section 55J of the Act to change the firm's permissions in certain circumstances, or to agree a voluntary variation of permission with the firm.<sup>(1)</sup>

(1) For more information see the PRA's Statement of Policy on the use of PRA powers to address serious failings in the culture of firms, available at [www.bankofengland.co.uk/pr/Pages/publications/powersculture.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/powersculture.aspx).

England, Wales or Northern Ireland, the PRA will apply the basic principles set out in the Code for Crown Prosecutors.

205. The PRA may also prohibit any individuals — not just those who currently hold a Significant Influence Function — from performing functions in relation to a regulated activity carried on by a PRA-authorised firm. The PRA may only do this

where it appears to the PRA that an individual is not a fit and proper person to perform such functions. The PRA will consider using this power in appropriate cases.

206. These powers are additional to those that the PRA holds in relation to Approved Persons (as detailed in Section III).

**Box 8****Supervision of firms that pose little individual risk to financial stability**

This box summarises the PRA's approach to supervising firms with the lowest potential impact on the stability of the financial system. There are a very large number of deposit-takers in this category, currently made up of small overseas banks (branches or subsidiaries) and credit unions.

At an individual level, these firms have almost no capacity to cause disruption to the UK financial system, either through the way they carry on their business or through idiosyncratic, orderly failure. Nevertheless, two considerations motivate a baseline level of supervisory monitoring for them. First, the PRA's general statutory objective is to promote the safety and soundness of all of the firms that it regulates. And second, there is a risk that problems across a whole sector or subsector could generate some disruption to the continuity of financial services, ie several firms may fail together through a common exposure, with possible wider systemic impact (as occurred in the 1990s 'small banks' crisis for example).

Given that such firms are likely to pose risks to financial stability at an aggregate level only, the PRA supervises them on a portfolio basis. Automated tools, analysing firms' regulatory returns, issue alerts highlighting outliers and trends, and firms are in general examined individually only when their regulatory returns trigger such an alert. The PRA also seeks to assure itself that these firms are resolvable, with a particular emphasis on their ability to facilitate depositor payout by the FSCS.

The PRA also examines individual firms when a risk crystallises (as discovered through, for example, a visit to the firm, or an

approach from the firm itself), or in response to authorisation requests from the firm (for example, a request to change its permissions to undertake regulated activities, or to extend the nature or scale of its business).

In addition, the PRA conducts peer group and trend analysis across sectors as a whole, to develop a clear understanding of the risks posed both by groups of low-impact firms and by typical firms in the sector. The PRA still conducts annual assessments of firms, but in large peer groups.

In contrast to the higher-impact firms, those in the lowest category contact the PRA through a centralised firm enquiries function and do not have an individual, named supervisor.

Firms in this category are not visited by the PRA on a fixed, regular schedule. Notwithstanding this approach, all firms, regardless of category, are subject to on-site work by the PRA — typically with a period of notice — at any time.

**Credit unions**

Credit unions are the major constituent of the lowest-impact category. They are subject to a specific prudential regime, as set out in the Credit Union Sourcebook, including specific minimum capital and liquidity requirements, their adherence to which is monitored as described above. Credit unions are not subject to the Capital Requirements Directive, nor are they issued with individual guidance for capital and liquidity.

Credit unions are required to meet standards for rapid payout of depositors by the FSCS, but are not otherwise required to have recovery and resolution plans. Those individual credit unions posing a risk of contagion to other firms, for example through having uninsured depositors, are subject to more intensive supervision.

## V Making policy to support the PRA's general approach

207. Prudential supervision is based on policies which ensure that judgements about risks to the PRA's objectives are made within a clear and coherent framework.

208. This section details the PRA's approach to setting and communicating these policies, common across all the firms that it regulates and relevant to both of its statutory objectives.

### The PRA's approach to published policy material

209. **The PRA aims to establish and maintain published policy material which is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible, so that it is usable by the senior management of firms.** Taken as a whole, the set of published policy material is intended to set out clearly and concisely what the PRA expects of firms in terms of intended outcomes, so that they can meet these expectations through their own actions. When the PRA judges that it is necessary to take action against a firm to mitigate risks to the PRA's objectives, the basis for its judgement should be clear from its published policies.

210. As noted in Box 4, the policy framework for the PRA's supervision is to a large extent agreed internationally, both at a global level, for example through the BCBS, and within the European Union. The policy framework is increasingly being codified at EU level. Relevant EU Directives are implemented in the United Kingdom through legally binding PRA rules. Relevant EU Regulations, including binding technical standards that apply directly to UK firms, will not be reproduced in the PRA's rulebook but will be part of the PRA's requirements of firms. Firms are also subject to guidance issued by the European Supervisory Authorities.

211. Where the PRA issues rules in areas not covered by EU law, it aims to do so in a manner which is clear about the intended outcome, straightforward to understand and as concise as possible to achieve this.

212. On 1 April 2013, the PRA adopted the prudential aspects of the *FSA Handbook*. The PRA is reviewing the *Handbook*, and will replace it with a rulebook, containing only the PRA's rules. The PRA intends to limit strictly the use of guidance material in the rulebook. Other relevant types of material currently in the *Handbook*, for example procedures manuals, and information on how the PRA itself will act, will be published separately.

213. The PRA does not plan to issue significant amounts of detailed guidance to clarify its policy, whether in the form of general guidance issued publicly or advice given by supervisors to individual firms. Where the PRA judges that general guidance material is required, this is issued in a consistent format as papers entitled Supervisory Statements. Such

material is focused on the PRA's expectations, aimed at facilitating firms' judgement in determining whether they meet these expectations, and will not be overly detailed.

214. Firms are expected to engage directly with policy material, including rules, EU material and Supervisory Statements, and determine — bearing in mind the overarching principle of safety and soundness — whether they meet the PRA's expectations.

### What the PRA does in delivering and maintaining its policy

215. **The PRA attaches great importance to being an influential and persuasive participant in international policy debates and negotiations.** It seeks agreement at both global and EU levels to policy reforms which deliver and maintain a strong, coherent and clear prudential framework that allows the PRA effectively to advance its objectives.

216. **The PRA performs careful analysis to determine whether and what revisions to its set of policies may be appropriate, whether negotiating policy internationally or acting autonomously.** The PRA only proposes or supports a policy reform where it is justified by the presence of current or potential market failures relating to its objectives; and where it believes that the net effect of the reform will be beneficial for the PRA's objectives. This includes consideration of the implications of PRA action for competition in the relevant markets. The PRA also has regard, in reaching its view, to the regulatory principles set out in the Act, UK economic growth, and differences in the nature and objectives of authorised persons. The PRA assesses the impact of its policy on regulated firms and the wider economy. Quantitative estimates of costs and benefits are included in its published documents only where they can reasonably or practicably be estimated.

217. The PRA actively reviews the continued effectiveness of its policies and their coherence, with the aim of ensuring that as the financial system develops, the prudential regime remains effective and proportionate.

218. **The PRA solicits comment on policy proposals, for example on the likely effect of proposed reforms and on different ways of achieving its intended policy outcome.** The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms. This will include consultation of the PRA Practitioner Panel and the FCA. The PRA aims to communicate policy proposals (including an analysis of their effect and an explanation of their purpose) to all parties likely to be affected by them. This is usually done through publication of a consultation on the PRA's website, in addition to other channels as appropriate. The PRA carefully considers the representations made to it. Consultation periods are consistent with Government guidelines.



## Box 9 Staffing the PRA

The PRA's approach to resourcing is to employ staff with the necessary skills to carry out the forward-looking, judgement-based approach to supervision necessary to advance its objectives.

The PRA's approach is advanced primarily by its front-line supervisors. These need to have the right capabilities to make judgements about current and future risks to an institution's safety and soundness, and to make interventions early before risks crystallise. Their judgements need to be grounded in analysis, supervisory experience, and a strong understanding of the sectors they supervise gained through direct exposure to the industry. On this basis they will have credibility with the senior management of firms, and be able to deliver robust messages.

The PRA's front-line supervisors are supported by risk specialists. These provide important knowledge and technical expertise to support analysis and supervisory judgements.

In addition, the PRA employs policy experts to develop the policies that underpin its supervision. Since, as noted above, the policy framework is to a large extent agreed internationally, the PRA seeks to ensure that its policy experts have the necessary skills and experience to influence international policy debates — at both global and EU levels — to ensure that the PRA's views are properly represented.

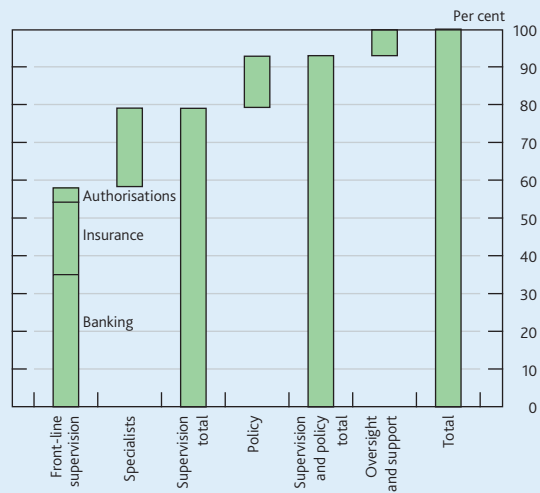
In delivering its objectives, the PRA will ensure that there is an efficient allocation of resources. As illustrated in **Chart A**, over 90% of staff are directly involved in supervision and policy. About 60% of staff are involved in front-line supervision with a further 30% performing policy and specialist roles. The PRA is structured as shown in **Figure A**.

The allocation of resources, illustrated in **Table 1**, shows that around one third of supervisory staff are focused on the 25 or so firms with the highest potential impact (Category 1); a further third are focused on the next 54 most significant firms (Category 2) while the remaining supervisors focus on around 1,300 lower-impact firms (in Category 3 and below).

The PRA's rank mix (**Chart B**) reflects its approach to advancing its objectives, with the highest proportion of senior and experienced supervisors responsible for supervising those firms that present the greatest risk to the financial system.

The PRA aims to have a larger proportion of more experienced and senior supervisors compared with the past. The process for delivering this has already started and implementation is

**Chart A** PRA split by function

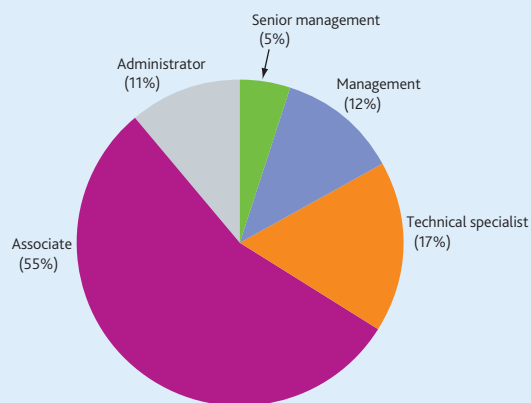


**Table 1** PRA resource allocation

- Category 1:** c. 25 firms (1.8% of total), 212 supervisors, average ratio of 8:1.
- Category 2:** c. 54 firms (4% of total), 133 supervisors, average ratio of 3:1.
- Category 3–5:** c. 1,257 firms (94% of total), 178 supervisors, average ratio of 0.1:1.

Note: These are approximate numbers.

**Chart B** PRA rank mix



continuing. This will involve development of the PRA's own supervisors as well as external recruitment. Internal career development is an important aspect of building the PRA's capability in the long term.

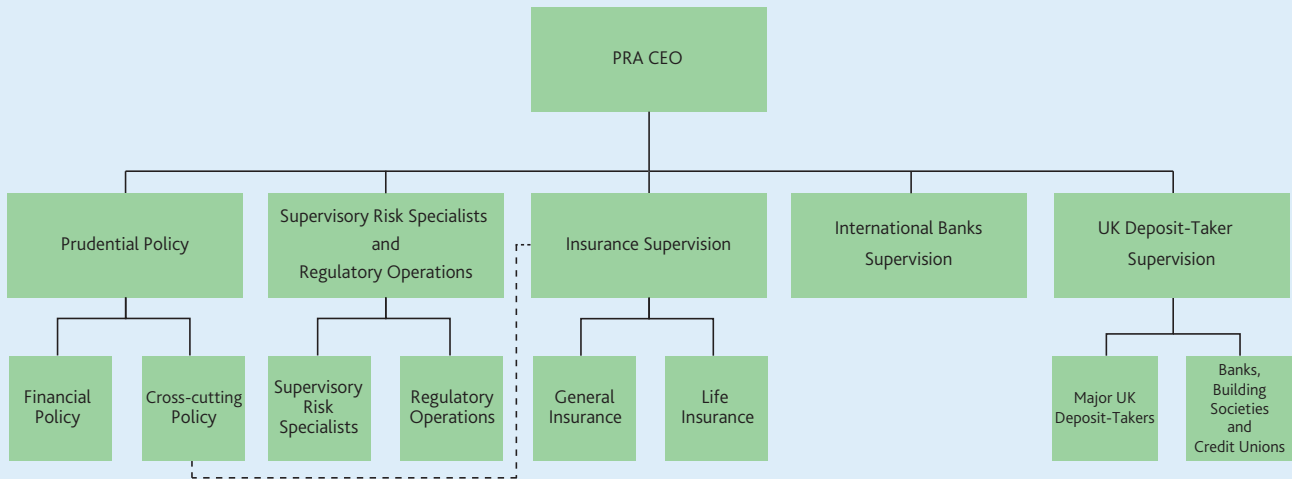
The Bank's recruitment, talent management and career development programmes have been extended across the PRA, the objective being to ensure that staff have the opportunity to develop to their full potential and that there is a strong pipeline of talented senior supervisors.

The PRA's focus on prudential supervision develops supervisors with in-depth experience of the key issues that pose a risk to the safety and soundness of firms and the PRA's objectives. It is important to ensure that this experience is retained for the

PRA to benefit fully from supervisors' regulatory knowledge and expertise. Retaining staff requires the PRA to offer compelling careers centred around intellectual challenge and excellence, and a commitment to public service through its public policy objectives. Graduates undertake a three-year development programme. And staff at all levels are coached by their managers on the exercise of supervisory judgement.

Secondment opportunities to the industry and overseas regulators are made available to staff. Additionally, staff have the opportunity to work in other parts of the Bank as a way of broadening their knowledge and management experience, and similarly the PRA is open to staff moving from other parts of the Bank.

Figure A PRA organisation structure<sup>(a)</sup>



(a) The figure shows the PRA's new organisation structure following on from the launch of the Bank's Strategic Plan. For more information see the Bank's public announcement, available at [www.bankofengland.co.uk/about/Pages/strategicplan/default.aspx](http://www.bankofengland.co.uk/about/Pages/strategicplan/default.aspx).

## Annex

This issue of *The PRA's approach to banking supervision* contains amendments reflecting feedback received and other recent developments. Key changes include:

- updates explaining the PRA's new secondary objective (page 5);
- addition of the PRA's 'Fundamental Rules' which replaces the 'Principles of Business' (page 5);
- addition of an extra box (Box 2) to list the PRA's Fundamental Rules (page 11);
- amendments to the Liquidity Assets section to further clarify PRA's approach and to reflect the PRA's announcement in August 2013 to change the liquidity asset requirements (page 26);
- additional text to clarify resolvability regime (page 28);
- addition of Box 7 to outline the use of PRA powers to address failings in culture in firms (page 36); and
- Box 9 has been updated to reflect the current staff information and the PRA's new organisation structure following on from the Bank's Strategic Plan.